(26,172)

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1917.

No. 705.

CHARLES A. PEABODY, PLAINTIFF IN ERROR,

vs.

MARK EISNER, COLLECTOR OF INTERNAL REVENUE.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

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... & Detweiler (Inc.), Printers, Washington, D. C., October 4, 1917.

(28,173)

1 *Writ of Error.*

UNITED STATES OF AMERICA, ss:

The President of the United States of America to the Judges of the District Court of the United States for the Southern District of New York, Greeting:

Because, in the record and proceedings, as also in the rendition of the judgment of a plea which is in the district Court, before you, or some of you, between Charles A. Peabody, plaintiff, and Mark Eisner, defendant, a manifest error hath happened, to the great damage of the said Charles A. Peabody, plaintiff, as appears by his complaint; We, being willing that such error, if any hath been, should be duly corrected, and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that then under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the Supreme Court of the United States, together with this writ, so that you have the same at the City of Washington within thirty days in the said Supreme Court of the United States, to be then and there held, that the record and proceedings aforesaid being inspected, the said Supreme Court of the United States may cause further to be done therein, to correct that error, what of right and according to the law and custom of the United States
2 ought to be done.

Witness, the Honorable Edward D. White, Chief Justice of said Supreme Court of the United States, this 22nd day of September, in the year of our Lord one thousand nine hundred and seventeen.

[SEAL.] ALEX. GILCHRIST, JR.,
Clerk of the District Court of the United States of America for the Southern District of New York, in the Second Circuit.

The foregoing writ is hereby allowed.

C. M. HOUGH,
U. S. Circuit Judge, Assigned to the District Court, Southern District of New York.

(Filed September 22, 1917.)

3 *Summons.*

United States District Court for the Southern District of New York.

Docket L. 17–117.

CHARLES A. PEABODY, Plaintiff,

against

MARK EISNER, Defendant.

To the above-named Defendant:

You are hereby summoned to answer the complaint in this action, and to serve a copy of your answer on the plaintiff's attorney within twenty days after the service of this summons, exclusive of the day of service; and in case of your failure to appear, or answer, judgment awill be taken against you by default for the relief demanded in the complaint.

Witness the Hon. Learned Hand, Judge of the District Court of the United States for the Southern District of New York, at the City of New York, this 6th day of July in the year one thousand nine hundred and seventeen.

[SEAL.] ALEX. GILCHRIST, JR., *Clerk.*

HENRY W. CLARK,
Plaintiff's Attorney.

Office and Post-office Address, 165 Broadway, New York City.

(Filed, with proof of service, July 7, 1917.)

4 *Complaint.*

United States District Court, Southern District of New York.

CHARLES A. PEABODY, Plaintiff,

against

MARK EISNER, Defendant.

The plaintiff above named, by Henry W. Clark, his attorney, complains of the defendant above named as follows:

For a First Cause of Action.

I. That defendant was at all times herein mentioned Collector of Internal Revenue of the United States, in and for the Third District of New York; and that the acts of defendant herein alleged were done under the direction of the Commissioner of Internal Revenue of the United States.

II. That this action arises under a statute of the United States providing for internal revenue, to wit, Section II of the Act of Congress entitled "An Act To reduce tariff duties and to provide revenue for the Government, and for other purposes," approved October 3, 1913, hereinafter referred to as the Income Tax Law.

5 III. That on January 8, 1914, the board of directors of the Union Pacific Railroad Company declared a dividend, designated as an extra dividend, payable to holders of the common capital stock of said Company registered as such on the books of the Company at 3 o'clock p. m. on March 2, 1914, consisting of the following upon each share of such common stock: First, $3 in cash; second, $12, par value, of preferred capital stock of the Baltimore and Ohio Railroad Company; third, $22.50, par value, of the common capital stock of the Baltimore and Ohio Railroad Company.

IV. That thereafter, on or about July 31, 1914, plaintiff, as a holder of Union Pacific Railroad Company common stock registered as such at 3 p. m. on March 2, 1914, received from said Union Pacific Railroad Company payment of the aforesaid extra dividend upon a holding of 1100 shares of said common stock, to wit: $3,300 in cash; 132 shares of Baltimore and Ohio preferred stock of the par value of $13,200; 247½ shares of Baltimore and Ohio common stock of the par value of $24,750.

V. That in March 1915 plaintiff filed with the defendant, as Collector of Internal Revenue, a return purporting to show the net income of the plaintiff for the calendar year 1914 subject to taxation under the Income Tax Law, and included therein, as income derived from the aforesaid extra dividend received by him, $4.12 upon each of the 1100 shares of his holding of Union Pacific

6 Railroad Company common stock or the total sum of $4,532; and thereafter plaintiff was assessed and paid to the defendant, as Collector of Internal Revenue, the income tax upon his net income returned as aforesaid.

VI. That thereafter, in the year 1917, defendant notified plaintiff of the assessment of an additional tax, at the rate of 4 per cent, upon the sum of $36,718 as additional net income for the calendar year 1914 derived from the aforesaid Union Pacific Railroad Company extra dividend; that said alleged additional net income was computed by valuing the Baltimore and Ohio Railroad Company stocks, both common and preferred, included in said extra dividend at their par value, thus determining the value of the entire extra dividend received by plaintiff to be $41,250, and deducting from said total value the sum of $4,532 theretofore returned by plaintiff for taxation as aforesaid, viz:

Cash	$3,300.00
132 shares Baltimore and Ohio preferred stock	13,200.00
247½ shares Baltimore and Ohio common stock	24,750.00
	$41,250.00
Less amount returned	4,532.00
Alleged additional net income	$36,718.00

and that defendant thereupon demanded of plaintiff payment of an additional tax of $1,468.73 upon said alleged additional net income together with $29.37 interest thereon.

7 VII. That thereafter and on or about the 16th day of May, 1917, pursuant to said notice and demand, plaintiff paid to defendant the sum of $1468.73 as additional tax and $29.37 as interest, a total of $1498.10, but unwillingly and under protest and solely in order to prevent the forcible collection of said tax and interest and to avoid the distraint and sale of his goods and property and other penalties provided by law for non-payment of such taxes.

VIII. That plaintiff has heretofore duly appealed to the Commissioner of Internal Revenue, in the form prescribed by said Commissioner, for the remission and cancellation of said additional assessment substantially upon the grounds hereinafter alleged, and said appeal has been rejected by the Commissioner of Internal Revenue.

IX. On information and belief: That on March 1, 1913, the date from which the Income Tax Law became and was effective, there were outstanding 2,166,338 shares of common stock of the Union Pacific Railroad Company of the par value of $100 each; that on said date said corporation had, according to its books of account, aggregate assets at the valuation ascribed to them by said corporation exceeding by $362,764,645.44 the aggregate par amount of its outstanding preferred capital stock and the amount of all corporate debts and liabilities of every character; that under the Articles of Incorporation of said corporation, the preferred stock having

8 regularly received the full amount of dividends to which it was limited by said Articles, the said $362,764,645.44 constituted the amount of capital and surplus of said corporation applicable exclusively to its common stock; and that, therefore, on said date the book value, according to the accounts of said corporation, of each share of said common stock then outstanding was $167.46.

X. That the 1100 shares of said Union Pacific Railroad Company common stock upon which plaintiff received said extra dividend in 1914 were owned by plaintiff on March 1, 1913, and long prior thereto, and, on information and belief, that said shares on March 1, 1913, represented an interest of plaintiff, as a stockholder, in the aggregate assets of said corporation to the amount, at book value, of $184,206.

XI. That the Board of Directors of the Union Pacific Railroad Company in and by their resolution declaring said extra dividend directed that the capital stock of the Baltimore and Ohio Railroad Company required to pay said extra dividend be charged off in the accounts of the Union Pacific Railroad Company at the rates or valuations of $80 per share for the Baltimore and Ohio preferred stock and $82 per share for the Baltimore and Ohio common stock, said rates being deemed by said Board of Directors to represent the fair and reasonable valuations of said stocks, and being the market prices prevailing therefor immediately prior to the public an-

9 nouncement of said extra dividend.

XII. On information and belief: That there was charged

off in the accounts of the Union Pacific Railroad Company on March 2, 1914, as the amount of said extra dividend upon 2,222,834 shares the sum of $74,020,372.20, computed as follows:

Cash $3 per share	$6,668,502.00
B. & O. preferred, 266,740.08 shares at $80 per share	21,339,206.40
B. & O. common, 500,137.65 shares at $92 per share	46,012,663.80
Total dividend	$74,020,372.20

constituting a charge of $33.30 on account of each share upon which said dividend was payable.

XIII. On information and belief: That at the close of business on March 2, 1914, the Union Pacific Railroad Company had outstanding 2,222,834 shares of common stock of the par value of $100 each, all of which had been registered at or prior to 3 o'clock p. m. on said date and was entitled to participate in said extra dividend; that at said time, after charging off said extra dividend as aforesaid, said corporation had, according to its books of account, aggregate assets at the valuation ascribed to them by said corporation exceeding by the amount of $307,238,741.99 the aggregate par amount of its outstanding preferred capital stock and the amount of all corporate debts and liabilities of every character; and that, therefore, at said time the book value, according to the accounts of said corporation, of each share of said common stock then outstanding was $138.22.

10 XIV. On information and belief: That plaintiff's 1100 shares of Union Pacific Railroad Company common stock at the close of business on March 2, 1914, represented an interest of plaintiff, as a stockholder, in the aggregate assets of said corporation, remaining after the charging off of said extra dividend, to the amount, at book value, of $152,042, and his interest in said extra dividend then vested amounted, at the valuation of $33.30 per share ascribed thereto by said corporation, to the sum of $36,630, together aggregating a value of $188,672, and exceeding the book value of $184,206 represented by said shares on March 1, 1913, as hereinbefore alleged, by only $4,466 or $4.06 per share.

XV. On information and belief: That the entire earnings, income, gains and profits from all sources realized by Union Pacific Railroad Company from March 1, 1913, to March 2, 1914, remaining after the payment of expenses, interest and regular dividends for said period and available for payment of the said extra dividend, shown by the books of said corporation or in any way recognized by said corporation, did not exceed the sum of $4.12 for each share of Union Pacific Railroad common stock outstanding on March 1, 1913; that the cash and Baltimore and Ohio Railroad Company stock disposed of in the payment of said extra dividend were on and prior to March 2, 1914, respectively, a part of the general cash in hand of said 11 Union Pacific Railroad Company and a part of its general securities owned and were not until appropriated for said extra dividend set apart, reserved or in any way distinguished from other assets available for all corporate purposes; and that said Union Pa-

cific Railroad Company does not set apart or reserve or identify in its books of account or in fact specific cash, securities or other assets as capital or specific cash, securities or other assets as profits, and does not attempt in its records and accounts or otherwise to distinguish and identify particular assets in respect of the source or means of their acquisition.

XVI. That, by reason of the facts aforesaid, plaintiff asserts that the balance of said extra dividend received by him (over and above the sum of $4,532 thereof, or $4.12 upon each of said 1100 shares, included as aforesaid in his tax return) did not constitute a gain, profit or income of the plaintiff arising or accruing after March 1, 1913, and was not a part of his taxable net income for the calendar year 1914 or for any period after March 1, 1913, within the meaning of the Income Tax Law; and that the assessment and collection of the aforesaid additional tax of $1468.73 thereon was unauthorized by law; and plaintiff further asserts that the assessment of said tax upon a property interest accrued to and possessed by plaintiff, as hereinbefore alleged, prior to March 1, 1913, constituted a direct tax levied without the apportionment required in the case of direct taxes by the provisions of Clause 3 of
12 Section 2 and Clause 4 of Section 9 of Article I of the Constitution of the United States and was therefore unconstitutional, null and void.

For a Second Cause of Action.

XVII. Plaintiff repeats and realleges as part of this second cause of action each and every allegation contained in paragraphs numbered I, II, III, IV, V, VI, VII, VIII, XI and XII of the first cause of action hereinbefore set forth.

XVIII. That by action of the Board of Directors of the Union Pacific Railroad Company the said extra dividend was made payable on and after July 20, 1914, upon presentation and surrender of the dividend warrants issued as hereinafter alleged, and actual payment thereof by said corporation was begun on said last mentioned date.

XIX. That, on or about March 2, 1914, Union Pacific Railroad Company issued to its common stockholders registered as such at 3 o'clock p. m. on said date, warrants certifying to the rights to which such stockholders, respectively, were entitled under the said extra dividend declaration, but, because of the institution and pendency of litigation by preferred stockholders of Union Pacific Railroad Company to enjoin the payment of said extra dividend, the Union Pacific Railroad Company prescribed the condition that the said extra dividend warrants and the rights represented
13 thereby would not be transferable prior to the date of actual payment of the extra dividend, except upon a corresponding transfer of the Union Pacific Railroad shares to which they respectively appertained, and, for the same reason, the New York Stock Exchange, constituting, the principal market in the United States for dealing in securities of the character of such dividend

warrants, adopted a rule preventing, until the date of actual payment of said extra dividend, any dealing in said dividend warrants or dividend rights separate and apart from a dealing in the shares to which they respectively appertained.

XX. That during the period after July 20, 1914, within which plaintiff could with the exercise of reasonable diligence have collected from Union Pacific Railroad Company the proceeds of his extra dividend warrant, there occurred extensive dealings on the New York Stock Exchange in Baltimore and Ohio common and preferred stocks at the prices of $75 per share for the common and $74 per share for the preferred and said prices were the fair and reasonable market value of said securities at the time when said extra dividend first became available to plaintiff.

XXI. That, by reason of the facts aforesaid, the value to the plaintiff represented by said extra dividend and balance thereof not included in his return of taxable net income were as follows:

14	Cash	$3,300.00
	132 shares B. & O. preferred at $74	9,768.00
	247½ shares B. & O. common at $75	18,562.50
	Total on 1100 U. P. R. R. common	$31,630.50
	Less amount returned by plaintiff	4,532.00
	Balance not returned	$27,098.50

XXII. That the income tax, at 4 per cent. upon the balance of the value of said extra dividend not returned by plaintiff as a part of his taxable net income would be $1083.94 and interest thereon, to the amount of 2 per cent. as charged by defendant, would amount to $21.68, a total of $1105.62, being less by the sum of $363.11 than the amount of tax and interest collected from plaintiff under protest as aforesaid.

Wherefore plaintiff demands judgment for the sum of $1498.10 under the first cause of action herein, or, if said first cause of action be not sustained, for the sum of $363.11 under the second cause of action herein, and in either case with interest from the 16th day of May, 1917.

HENRY W. CLARK,
Attorney for Plaintiff.

Office and Post Office Address, 165 Broadway, Manhattan Borough, New York City.

STATE OF NEW YORK,
County of New York, ss:

15 Charles A. Peabody, being duly sworn, deposes and says that he is the plaintiff in this action; that he has read the foregoing complaint and knows the contents thereof; and that the same is true to the knowledge of deponent except as to the

matters therein stated to be alleged on information and belief, and that as to those matters he believes it to be true.

CHARLES A. PEABODY.

Sworn to before me this 3rd day of July, 1917.

[SEAL.] PHILIP V. R. SCHUYLER,
Notary Public, New York County, No. 81.

(Filed July 7, 1917.)

16 *Demurrer to Complaint.*

United States District Court, Southern District of New York.

Docket L. 17-117.

CHARLES A. PEABODY, Plaintiff,

vs.

MARK EISNER, Defendant.

The defendant demurs to the complaint herein, and each cause of action thereof, on the ground that as appears on the face thereof, it does not state facts sufficient to constitute a cause of action.

FRANCIS G. CAFFEY,
United States Attorney for the Southern District of New York, Attorney for Defendant.

Office and Post Office Address, U. S. Courts & P. O. Building, Borough of Manhattan, City of New York.

Dated New York, August 7th, 1917.

STATE, COUNTY AND SOUTHERN DISTRICT OF NEW YORK, ss.:

Ben A. Matthews, being duly sworn, deposes and says that he is Assistant United States Attorney and as such, has charge of the above entitled action; that the above demurrer is not interposed for delay, but he verily believes that each cause of action of the complaint is bad in law.

BEN A. MATTHEWS.

Subscribed and sworn to before me this 7th day of August, 1917.

CARL BRECHER,
Notary Public, Bronx Co., No. 72.

Certificate filed in N. Y. Co. No. 477.
Register's No. Bronx Co. No. 969.
Register's No. N. Y. Co. No. 9041.
My commission expires Mar. 30, 1919.

(Filed August 8, 1917.)

17 *Stipulation.*

United States District Court, Southern District of New York.

Docket L. 17-117.

CHARLES A. PEABODY, Plaintiff,

against

MARK EISNER, Defendant.

Stipulated and consented in the above entitled case as follows:

1. That judgment be rendered in favor of the plaintiff under the second cause of action set forth in the complaint upon the basis of a valuation of the Baltimore and Ohio Railroad Company common and preferred stocks mentioned therein at $92 and $80 per share respectively, said prices being deemed to represent the market value appertaining to said stocks on or about January 8, 1914.

2. That the computation of the amount for which judgment is to be rendered in favor of the plaintiff as aforesaid is as follows:

Cash dividend received by plaintiff	$3,300.00
132 shares of B. & O. preferred stock at 80	10,560.00
247½ shares " common " " 92	22,770.00
Total valuation of dividend received by plaintiff.	$36,630.00
Returned by plaintiff for taxation	4,532.00
Balance	$32,098.00
Tax thereon at 4 per cent	1,283.92
2% interest thereon as charged by defendant	25.68
Total tax and interest	$1,309.60
Amount collected by defendant May 16, 1917	1,498.10
Balance—excess collection	$188.50

18 3. This stipulation and the entry of judgment in accordance herewith shall be without prejudice to the claims of the plaintiff under the first cause of action set forth in the complaint herein, it being the sole purpose of this stipulation to waive the claim of plaintiff under the second cause of action that the Baltimore and Ohio stocks received by him as a part of said extra dividend of the Union Pacific Railroad Company should be valued for taxation on the basis of the market prices therefor prevailing on and after July 20, 1914, when said dividend became payable, but without abandoning the contention of plaintiff under the first cause of action for the recovery of

the entire additional income tax collected upon said extra dividend May 16, 1917.

Dated September 6, 1917.

HENRY W. CLARK,
Attorney for Plaintiff.
FRANCIS G. CAFFEY,
United States Attorney, Attorney for Defendant.

(Filed September 6, 1917.)

19 *Opinion.*

Docket L. 17-117.

PEABODY

v.

EISNER.

The first cause of action is deemed to be ruled against the plaintiff by the decisions in this district in Southern Pacific Company v. Lowe, 238 Federal 847 [Manton, J.] and Towne v. Eisner, Docket L. 17-273 decided June 15, 1917, and not yet reported [A. N. Hand, J.].

J. M. M., *D. J.*

(Filed September 6, 1917.)

20 *Order on Demurrer.*

At a Stated Term of the United States District Court for the Southern District of New York, Held in the Post Office Building, in the Borough of Manhattan, City of New York, on the 6th Day of September, 1917.

Present: Honorable Julius M. Mayer, United States District Judge.

Docket L. 17-117.

CHARLES A. PEABODY, Plaintiff,

against

MARK EISNER, Defendant.

The issues of law raised by the demurrer of the defendant to the complaint herein having duly come on to be heard, and after hearing Ben A. Matthews, Esq., Assistant United States Attorney, of counsel for defendant in support of said demurrer, and Henry W. Clark, Esq., of counsel for plaintiff, in opposition thereto, and the Court being of the opinion that the demurrer to the first cause of action set forth in the complaint should be sustained, and the parties having stipulated, but without prejudice to the disposition of the

first cause of action, that judgment be rendered in favor of plaintiff under the second cause of action set forth in the complaint upon a basis specified in said stipulation;

Now, upon motion of Francis G. Caffey, Esq., United
21 States Attorney, attorney for the defendant, it is

Ordered that the demurrer to the first cause of action set forth in the complaint be and the same hereby is sustained, and that said first cause of action be and the same hereby is dismissed, but without costs; and

Ordered that the demurrer to the second cause of action set forth in the complaint be and the same is hereby overruled, and that the plaintiff have final judgment against the defendant for the recovery under said second cause of action of $188.50 with interest thereon from the 16th day of May, 1917, amounting to $2.89, a total of $191.39, but without costs.

JULIUS M. MAYER,
United States District Judge.

(Filed September 6, 1917.)

22 *Certificate of Probable Cause.*

United States District Court, Southern District of New York.

Docket L. 17-117.

CHARLES A. PEABODY, Plaintiff,

vs.

MARK EISNER, Defendant.

I hereby certify pursuant to Section 989 of the Revised Statutes of the United States that there was probable cause for the acts of the defendant in the above entitled case, and that he acted under the directions of the Commissioner of Internal Revenue.

Dated September 10, 1917.

JULIUS M. MAYER,
United States District Judge.

I hereby consent to the entry of the foregoing certificate.

HENRY W. CLARK,
Attorney for Plaintiff.

(Filed September 11, 1917.)

23 *Final Judgment.*

United States District Court, Southern District of New York.

Docket L. 17-117.

CHARLES A. PEABODY, Plaintiff,

against

MARK EISNER, Defendant.

Upon the order of this court duly made and filed on the 6th day of September, 1917, after hearing the issues of law raised by the demurrer to the complaint herein; and upon motion of Francis G. Caffey, Esq., United States Attorney, attorney for the defendant, it is

Adjudged that the first cause of action set forth in the complaint be and the same is hereby dismissed, but without costs; and

Adjudged that the plaintiff recover of the defendant under the second cause of action set forth in the complaint the sum of $188.50, with interest thereon from the 16th day of May, 1917, amounting to $2.89, a total of $191.39, but without costs.

Judgment signed this 14th day of September, 1917.

ALEX. GILCHRIST, JR., *Clerk.*

24 *Petition for Writ of Error.*

United States District Court, Southern District of New York.

L. 17-117.

CHARLES A. PEABODY, Plaintiff,

vs.

MARK EISNER, Defendant.

To the Honorable the Judges of the District Court of the United States for the Southern District of New York:

Now comes Charles A. Peabody, plaintiff in the above entitled cause and complains that in the rendition of judgment in said cause on the 14th day of September, 1917, and in the record and proceedings had in said cause, certain errors were committed to the great damage of this plaintiff, all of which will more in detail appear from the assignment of errors which is filed with this petition.

Wherefore plaintiff prays that a writ of error in his behalf from the Supreme Court of the United States, for the correction of the errors so complained of, be allowed and issued.

Dated September 21st, 1917.

HENRY W. CLARK,
Attorney for Plaintiff.

165 Broadway, New York City.

Above petition granted this 21 day of September, 1917.

C. M. HOUGH,
United States Circuit Judge, Assigned to the District Court.

(Filed September 22, 1917.)

25 *Assignment of Errors.*

United States District Court, Southern District of New York.

CHARLES A. PEABODY, Plaintiff,

vs.

MARK EISNER, Defendant.

Now comes Charles A. Peabody, plaintiff in the above entitled cause, and in connection with his petition for writ of error from the Supreme Court of the United States filed herewith, assigns the following errors in the proceedings in this cause and in the final judgment rendered herein by the District Court of the United States for the Southern District of New York on the 14th day of September, 1917, viz:

1. The Court erred in sustaining the demurrer to the first cause of action set forth in the complaint and dismissing said cause of action.

2. The Court erred in not holding and deciding that the dividend received by plaintiff upon which the tax in suit was assessed, in view of the facts alleged in the first cause of action of the complaint, did not constitute a gain, profit or income of the plaintiff arising or accruing on or after March 1, 1913, within the meaning of the statute under which said tax was assessed.

26 3. The Court erred in not holding and deciding that the taxation of said dividend, under the facts alleged in the first cause of action of the complaint would constitute a levy of direct taxation without the apportionment required by the provisions of Clause 3 of Section 2 and Clause 4 of Section 9 of Article I of the Constitution of the United States.

Wherefore plaintiff prays that the judgment and order of the District Court of the United States herein in so far as the same concern the first cause of action in the complaint be reversed.

Dated September 21st, 1917.

HENRY W. CLARK,
Attorney for Plaintiff.

(Filed September 22, 1917.)

27 *Bond on Appeal.*

United States District Court, Southern District of New York.

L. 17-117.

CHARLES A. PEABODY, Plaintiff in Error,

vs.

MARK EISNER, Defendant in Error.

Know all men by these presents:

That the undersigned, National Surety Company, a corporation organized under the laws of the State of New York, with its principal place of business at No. 115 Broadway, in the City, County and State of New York, as surety for the above named Charles A. Peabody, plaintiff-in-error, is held and firmly bound unto the above named Mark Eisner, defendant-in-error, in the sum of Two hundred and fifty dollars ($250) to be paid to the said Mark Eisner, for the payment of which well and truly to be made, the undersigned binds itself and its successors firmly by these presents.

Sealed with the corporate seal of the undersigned and dated the 15th day of September, 1917.

Whereas, the above named Charles A. Peabody has prosecuted a writ of error from the Supreme Court of the United States to reverse a final judgment rendered in the above entitled cause by the District Court of the United States for the Southern District of New
28 York on the 14th day of September, 1917;

Now, therefore, the condition of this obligation is such that if the above named Charles A. Peabody shall prosecute said writ of error to effect and answer all costs if he fail to make said appeal good then this obligation shall be void, otherwise the same shall be and remain in full force and virtue.

NATIONAL SURETY COMPANY,
By H. E. EMMETT, *Resident Vice-President.*

Attest:
[SEAL.] E. M. McCARTHY,
Resident Assistant Secretary.

The foregoing bond approved this 21 day of September, 1917.

C. M. HOUGH,
United States Circuit Judge,
Assigned to the District Court.

(Attached thereto is certificate of acknowledgment and affidavit of justification by said H. E. Emmett, which is omitted from the transcript.)

(Filed September 22, 1917.)

29 *Citation.*

L. 17-117.

UNITED STATES OF AMERICA, *ss:*

To Mark Eisner, Greeting:

You are hereby cited and admonished to be and appear before the Supreme Court of the United States at the City of Washington, D. C., within thirty days from the date hereof, pursuant to a writ of error filed in the Clerk's office of the District Court of the United States for the Southern District of New York, wherein Charles A. Peabody is plaintiff-in-error and you are defendant-in-error, to show cause, if any there be, why the judgment rendered against the plaintiff-in-error as in said writ of error mentioned, should not be corrected and why speedy justice should not be done in that behalf.

Given under my hand at the Borough of Manhattan, in the City of New York, in the Southern District of New York, this 21 day of September, in the year of our Lord One Thousand Nine Hundred and Seventeen.

C. M. HOUGH,
U. S. District Judge, Assigned to the District Court, Southern District of New York.

Endorsed: United States Supreme Court. Charles A. Peabody, plaintiff-in-error, vs. Mark Eisner, defendant-in-error. Citation. Henry W. Clark, attorney for plaintiff, 165 Broadway, New York City. A copy of the within paper has been this day received at this office Sep. 22, 1917. Francis G. Caffey, United States Attorney.

30 *Stipulation on Appeal Record.*

United States District Court, Southern District of New York.

CHARLES A. PEABODY, Plaintiff,

vs.

MARK EISNER, Defendant.

It is hereby stipulated and agreed, that the foregoing is a true transcript of the record of the said District Court in the above-entitled matter as agreed on by the parties.

Dated September 24, 1917.

HENRY W. CLARK,
Attorney for Plaintiff.
FRANCIS G. CAFFEY,
Attorney for Defendant.

31 UNITED STATES OF AMERICA,
Southern District of New York, ss:

CHARLES A. PEABODY, Plaintiff,

vs.

MARK EISNER, Defendant.

I, Alexander Gilchrist, Jr., Clerk of the District Court of the United States of America for the Southern District of New York, do hereby Certify that the foregoing is a correct transcript of the record of the said District Court in the above-entitled matter as agreed upon by the parties.

In testimony whereof, I have caused the seal of the said Court to be hereunto affixed, at the City of New York, in the Southern District of New York, this twenty-fifth day of September in the year of our Lord one thousand nine hundred and seventeen and of the Independence of the said United States the one hundred and forty-second.

[Seal District Court of the United States, Southern District of N. Y.]

ALEX GILCHRIST, Jr., *Clerk.*

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In the Supreme Court of the United States.

OCTOBER TERM, 1917.

CHARLES A. PEABODY, PLAINTIFF IN error,
v.
MARK EISNER, COLLECTOR OF INTERNAL revenue.
} No. 705.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

MOTION ON BEHALF OF DEFENDANT IN ERROR TO DISMISS AND BRIEF IN SUPPORT.

Now comes the Solicitor General, and, on behalf of the defendant in error, moves to dismiss the writ of error in the above-entitled cause for lack of jurisdiction.

BRIEF IN SUPPORT OF MOTION.

This writ of error is prosecuted under section 238 Judicial Code, and the only basis claimed for it is that the case is one "that involves the construction or application of the Constitution of the United States," or is one "in which the constitutionality of a law of the United States is drawn in question." An examination of the record shows clearly, however, that the case (*a*) either does not involve the Constitu-

tion of the United States in the sense required by the uniform decisions of this court, but involves merely the construction of Section II, subsection A, subdivisions 1, 2, and subsection B, of the act of October 3, 1913, 38 Stat. 114, 166, 167, c. 16, or (*b*) raises a constitutional question which has been so recently and completely determined by decisions of this court as to be frivolous.

On January 8, 1914, the directors of the Union Pacific Railroad Company declared a dividend, designated as an extra dividend, payable to holders of the common stock of said company registered as such on March 2, 1914 (of whom the plaintiff in error was one), of cash, and stock of the Baltimore and Ohio Railroad Company, held by the Union Pacific Railroad Company as part of its assets. The major portion of this extra dividend was derived from assets held by the Union Pacific Railroad Company prior to March 1, 1913. The plaintiff in error received his proportion of said extra dividend, but failed to return as income for the year 1914 any portion of it derived from assets accumulated prior to March 1, 1913. The defendant in error, as collector, being of the opinion that all of this extra dividend so received during the year 1914 was income for said year, assessed an additional tax covering the same which the plaintiff in error paid under protest, and which he now sues to recover back. (Rec. 3, 4, pars. III, IV, V, VI, VII, and VIII.) The complaint concludes (R. 6, par. 16) with an allegation that the portion of said extra dividend which plaintiff failed to return

did not constitute income to him arising or accruing after March 1, 1913, and was not a part of his taxable net income for the calendar year 1914 within the meaning of the Income Tax Law; and with the further allegation that the assessment of the tax upon a property interest accrued to and possessed by the plaintiff prior to March 1, 1913, constituted a direct tax levied without the apportionment required by the Constitution of the United States, and was therefore unconstitutional.

(*a*) It is evident that the substantial, if not the only, question in the case was whether this distribution of cash and stock of other corporations constituted income for the year 1914 under a proper construction of the act. No claim was made by anybody that the United States had power under the Constitution to tax capital directly without apportionment. The only question was whether this distribution of cash and stock of other corporations was a mere readjustment of capital, or whether, on account of the additional advantage derived by the stockholder therefrom, it constituted income. The Constitution may have been appealed to as an aid in the construction of the statute, but the case turned, nevertheless, upon that construction, and an error made by the court in interpreting the statute must be corrected in the manner provided by law. The constitutionality of the act of October 3, 1913, in so far as it levied a tax on incomes, could not, of course, be drawn in question by anybody since the decision of this court in *Brushaber* v. *Union Pacific R. R. Co.*,

240 U. S. 1. The question as to what is "income" and what is "capital" is, it is true, still open in every case, but that is a question to be determined by a construction of the statute and does not, in any true sense, involve the Constitution. Nor does the statement in the complaint that the Constitution is involved and that the constitutionality of a law of the United States is drawn in question help matters. *Lampasas* v. *Bell*, 180 U. S. 276, 282; *Arbuckle* v. *Blackburn*, 191 U. S. 405, 415. This proceeding, therefore, is merely an attempt to avoid the legal, commonplace steps of a writ of error from the Circuit Court of Appeals with a right to apply to this court for a certiorari.

It is submitted that the case falls directly within the rule laid down in the following decisions of this court: *Cornell* v. *Green*, 163 U. S. 75, 78, 80; *Lampasas* v. *Bell*, *supra*; *Arbuckle* v. *Blackburn*, *supra*; *Cosmopolitan Mining Co.* v. *Walsh*, 193 U. S. 460, 471, 472; *Sloan* v. *United States*, 193 U. S. 614, 620; *Taylor* v. *Taft*, 203 U. S. 461, 464; *American Sugar Refining Co.* v. *United States*, 211 U. S. 155, 161, 162; *Rakes* v. *United States*, 212 U. S. 55, 58; *Childers* v. *McClaughry*, 216 U. S. 139; *Norton* v. *Whiteside*, 239 U. S. 144, 147; *Lamar* v. *United States*, 240 U. S. 60, 65; *Chin Fong* v. *Backus*, 241 U. S. 1, 5.

Certain of the more significant of these cases may properly be referred to more specially. In *Arbuckle* v. *Blackburn*, 191 U. S. 405, the dairy and food commissioner of the State of Ohio ruled that the plaintiff's product was adulterated within the meaning of the

State pure food act, and did not come within the proviso exempting articles not injurious to health. It was claimed that if this construction was correct it would render the act unconstitutional. This court dismissed the appeal for the reason that no constitutional question was involved, and said (p. 415):

> The suggested controversy was purely hypothetical and based the supposed constitutional objections on the contingency that, on issues of fact, it might be judicially determined that Ariosa came within the statute, which complainants denied.
>
> If the commissioner's conclusions were erroneous, the courts were open for the correction of the error, and the possibility that they might agree with the commissioner could not be laid hold of as tantamount to an actual controversy as to the effect of the Constitution, on the determination of which the result of the present suit depended. Indeed, in the only case called to our attention by counsel involving the status of Ariosa, the Court of Common Pleas of Lucas County, Ohio, held that it was not within the prohibition of the statute. *White* v. *Ohio*, 12 Ohio Nisi Prius Decisions, 659.
>
> Reference to the Constitution to strengthen objections to a particular construction, or the pursuit of a certain course of conduct, is not sufficient to invoke jurisdiction. * * *

In *Cosmopolitan Mining Co.* v. *Walsh*, 193 U. S. 460, it was claimed that the plaintiff in error had been deprived of its property without due process of law

contrary to the Constitution of the United States, because the statute of Colorado when properly construed permitted a judgment to be rendered against it without proper service. The writ of error was dismissed for lack of jurisdiction, the court saying (pp. 471, 472):

> It is obvious, under the construction of the judiciary act of 1891, announced in the cases just referred to, that this cause does not involve the construction or application of the Constitution of the United States, and therefore was not entitled to be brought directly to this court from the Circuit Court of the United States. When the proceedings at the trial are taken into view it is clear that the contentions which were urged did not require the construction of the Constitution of the United States, but simply called for the construction of the constitution and laws of the State of Colorado or the application of the principles of general law. * * *
>
> * * * The claim asserted under the Constitution of the United States was, therefore, merely conjectural and amounted to this only, that if under the law of Colorado or under the general law the service on the alleged agent was void, that it would be a violation of the Constitution of the United States to give effect to judgments based on such service. Not only the statement we have made from the record, but the argument at bar, makes this a demonstration. Thus, in the discussion at bar, it was stated that it was not claimed that the State of Colorado could not without a vio-

lation of the Constitution of the United States have exacted that the authority conferred by a foreign corporation upon an agent to receive service of process should continue for the purpose of the enforcement of obligations contracted by the corporation, although the corporation had ceased to do business within the State, but that as the Colorado law when properly construed did not so provide, therefore the service was invalid, and the sale of the property of the mining company based on such service was void. This, however, as we have already shown, amounts but to the concession that the substantial controversy which the case presented involved the mere determination of what was the law of Colorado on the subject. The rulings of the court below as to the admissibility of evidence and its final direction of a verdict involved necessarily deciding that the service upon the agent was valid by the law of Colorado, or the principles of general law applicable thereto, and its action in so doing in nowise involved the construction or application of any provision of the Constitution of the United States.

In *Sloan* v. *United States*, 193 U. S. 614, the complainants brought suit for the purpose of maintaining their rights to certain allotments to Indians granted by a law of the United States. The act itself referred to a treaty of 1865 between the United States and the Omahas, and both the complainant and the United States referred to this and other treaties as part of their case. The appeal was dismissed on the

ground that the construction of the treaties was not involved within the meaning of section 238 of the Judicial Code, the court saying (pp. 620, 621):

> * * * The construction of a treaty is used only as an argument upon the issue directly in question, viz, the construction of the statute. The alleged right to an allotment being based upon the act of 1882, and the defence being also based upon the proper construction of that act, we cannot but regard the case as one simply resting on such act. The construction of these various treaties was not substantially or in any other than a merely incidental or remote manner drawn in question, and therefore a direct appeal to this court cannot be sustained.
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> * * * * * * *
>
> * * * In order to come within the act of 1891 the treaty must be directly involved, and upon its construction the rights of the parties must rest. Within these cases it cannot be said that the construction of any treaty is drawn in question herein when the rights of neither party are necessarily dependent upon such construction, but are dependent upon that which may be given the statute of 1882, and when the construction of that statute is independent of that which may be given any of the treaties mentioned, although weight may be given to the treaties in determining the question of the construction of the statute.

In *American Sugar Refining Co.* v. *United States*, 211 U. S. 155, it was claimed that certain regulations issued by the Secretary of the Treasury in regard to

customs dues on sugar added something not contained therein to the requirements of the act, and in this way constituted an exercise of legislative power in violation of the Constitution. The court, in dismissing the appeal for lack of jurisdiction, said (pp. 161, 162):

> This is conceded, and counsel for appellant attempt to sustain the jurisdiction on the ground that the regulations assumed to add something to the dutiable standard prescribed by the tariff act, and that in doing so the Secretary exercised legislative power confided by the Constitution solely to Congress. But this does not constitute a real and substantial dispute or controversy concerning the construction or application of the Constitution upon which the result depends.
>
> The admitted duty of the Secretary of the Treasury was to construe as best he could the paragraph relating to collection of duty upon sugars, and to promulgate regulations for carrying it into effect. Rev. Stat. §251. This and this alone he did. The only real substantial point involved is whether or not he misconstrued the statute, and that gives this court no jurisdiction upon direct appeal. *Sloan* v. *United States*, 193 U. S. 614, 620, and cases cited; *United States ex rel. Taylor* v. *Taft, Secretary*, 203 U. S. 461.
>
> Undoubtedly Congress, without violating any constitutional provision, could have in terms directed exactly what was prescribed by the Treasury regulations; and prior deci-

sions have held that the statute was properly construed by the Secretary.

We concur with counsel for the Government that if the construction or application of the Constitution of the United States, within the meaning of § 5, act of 1891, is involved in every case where one claims that, according to his interpretation of a statute, excessive duty or tax has been demanded by executive officers, the provisions of that act making decisions of the Circuit Court of Appeals in revenue cases final are of very limited value, and this court must entertain direct appeals from the Circuit Courts in most tariff and tax controversies, which we regard as out of the question.

(*b*) The claim apparently made in paragraph 16 of the complaint (R. 6) that a tax properly levied upon *income* under the provisions of the act of October 3, 1913, becomes unconstitutional if the income be derived from capital accumulated prior to March 1, 1913, is wholly frivolous, the point having been determined by this court adversely to the claim in *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, and *Edwards* v. *Keith*, 231 Fed. 110, writ of certiorari denied, 243 U. S. 638.

It is submitted, therefore, that the writ of error in the present case should be dismissed for lack of jurisdiction.

JOHN W. DAVIS,
Solicitor General.

NOVEMBER, 1917.

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Office Supreme Court, U. S.
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JAMES D. MAHER,
Clerk.

Supreme Court of the United States.

OCTOBER TERM, 1917.

No. 705.

CHARLES A. PEABODY,

Plaintiff-in-Error.

vs.

MARK BISNER,

Defendant-in-Error.

BRIEF FOR PLAINTIFF-IN-ERROR.

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Supreme Court of the United States,

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No. 705.

CHARLES A. PEABODY,
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vs.

MARK EISNER,
Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR PLAINTIFF-IN-ERROR.

Statement of the Case.

The case comes to this Court by writ of error to review a final judgment of the District Court, rendered upon a demurrer to the complaint and upon a stipulation, in so far as the judgment sustained the demurrer to the first cause of action of the complaint and dismissed said cause of action.

The suit is for the recovery of an amount exacted

from the plaintiff by the defendant, an internal revenue collector, as an income tax, the assessment and collection of which are asserted by plaintiff to have been illegal.

In 1914 the Union Pacific Railroad Company declared and paid an extra dividend, consisting of the following upon each share of its common stock: First, $3 in cash; second, $12 in par value of preferred capital stock of the Baltimore and Ohio Railroad Company; third, $22.50 in par value of common capital stock of the Baltimore and Ohio Railroad Company. The plaintiff-in-error, who was also the plaintiff below and will be hereinafter referred to as the plaintiff, received as the proceeds of said dividend upon his holding of 1100 shares of Union Pacific common stock $3,300 in cash, 132 shares of Baltimore & Ohio preferred stock and 247.5 shares of Baltimore & Ohio common stock. In his income tax return for 1914 he included as taxable income $4.12 of said dividend per share of his Union Pacific stock, or a total of $4,532, and was assessed and paid income tax upon his net income so returned. In 1917 an additional assessment amounting to $1,468.73, was made against the plaintiff on $36,718 as the balance of his said dividend, as valued by the Commissioner of Internal Revenue, which tax together with $29.37 interest thereon was paid under protest. [Complaint, paragraphs II to VII; Record, pp. 3 and 4]. Appeal was taken to the Commissioner of Internal Revenue without success [Complaint, paragraph VIII, Record, p. 4].

The complaint consists of two causes of action: First, for the recovery of the whole amount of the additional tax and interest collected in 1917, on the ground of the entire invalidity of the assessment, and, second, for the recovery of a part thereof, on the ground of an over-valuation of the Baltimore & Ohio shares included in said dividend. The defendant demurred to each cause of action, but thereafter stipulated that the value of the Baltimore & Ohio shares, taken at par as the basis of the assessment, was on the date of declaration of the dividend $92 for the common and $80 for the preferred, and that judgment be rendered for the plaintiff under the second cause of action, on the basis of this valuation, for the recovery of $188.50, this stipulation being without prejudice to the claims of the plaintiff under the first cause of action [Stipulation, Record, p. 9].

The District Court, considering that the first cause of action was ruled against the plaintiff in that court by the decisions in *Southern Pacific Company* v. *Lowe*, 238 Fed. 847, and *Towne* v. *Eisner*, 242 Fed. 702, sustained the demurrer to the first cause of action and dismissed the same, awarding the plaintiff only the aforesaid stipulated recovery under the second cause of action [Record, pp. 10, 11 and 12].

On March 1, 1913, the date from which the income tax law became effective, the capital and surplus of the Union Pacific Railroad Company applicable exclusively to its common stock amounted to $167.46 per share of its common stock [Complaint, paragraph

IX; Record, p. 4]. The extra dividend was charged off on the books of the corporation at a valuation of $33.30 per share of the Union Pacific common stock (based on $92 and $80 per share as the values of the Baltimore & Ohio common and preferred stocks respectively) on March 2, 1914, the date on which the dividend vested [Complaint, paragraphs XI and XII, Record, pp. 4 and 5]. At the close of business on March 2, 1914, after so charging off the extra dividend, the capital and undistributed surplus remaining, applicable exclusively to the common stock, amounted to $138.22 per share [Complaint, paragraphs XII and XIII; Record, p. 5]. Therefore, on March 2, 1914, the plaintiff's interest in the capital and undistributed surplus of the corporation amounted to $138.22 per share and his interest in the extra dividend then vested in him amounted to $33.30 per share, an aggregate of $171.52 per share [Complaint, paragraph XIV; Record, p. 5]. This aggregate exceeded his interest in the capital and surplus on March 1, 1913 [$167.46] by the amount of only $4.06 per share. It results therefrom that the balance of the dividend, over and above $4.06 per share, was paid out of the corporate profits accumulated prior to March 1, 1913. This result is confirmed by the allegation of the complaint that the entire earnings, income, gains and profits from all sources realized by Union Pacific Railroad Company from March 1, 1913, to March 2, 1914, remaining after the payment of expenses, interest and regular dividends for said period, and available for the payment of the said extra dividend, did

not exceed the sum of $4.12 for each share of its common stock [Complaint, paragraph XV; Record, p. 5], the amount per share voluntarily returned by the plaintiff and taxed against him as income of 1914 [Complaint, paragraph V; Record, p. 3].

Specification of Errors.

(*Assignment of Errors, Record, page 13.*)

1. The Court erred in not holding and deciding that the dividend received by plaintiff, upon which the tax in suit was assessed, in view of the facts alleged in the first cause of action of the complaint, did not constitute a gain, profit, or income of the plaintiff arising or accruing on or after March 1, 1913, within the meaning of the statute under which said tax was assessed.

2. The Court erred in not holding and deciding that the taxation of said dividend, under the facts alleged in the first cause of action of the complaint, would constitute a levy of direct taxation without the apportionment required by the provisions of Clause 3 of Section 2 and Clause 4 of Section 9 of Article I of the Constitution of the United States.

ARGUMENT.

POINT I.

This Court has Jurisdiction.

The right to a direct review by this Court under Section 238 of the Judicial Code is predicated upon the question concerning the application of the Constitution of the United States stated in the second paragraph of the foregoing specification of errors. That question was asserted in the complaint [paragraph XVI, Record, p. 6], presents an actual and substantial controversy and was necessarily involved in the decision of the case by the District Court.

Motion to dismiss for want of jurisdiction was submitted on the part of the defendant-in-error on December 10, 1917, and no decision of that motion has been announced. In support of this Court's jurisdiction reference is made to the brief filed in behalf of the plaintiff-in-error in opposition to said motion to dismiss and to the presentation of the Constitutional question in Point III, *post*, of this brief.

In addition, it is submitted that jurisdiction is established by the decision of this Court rendered on January 7, 1918, in *Towne* v. *Eisner*, No. 563. The Constitutional question relied upon to sustain the jurisdiction in that case was identical with the Constitutional question asserted in the present case, and the objection on the part of the Government to the jurisdiction in that case was upon identical grounds with the motion

to dismiss in the present case. The jurisdictional question was fully considered and the jurisdiction sustained in *Towne* v. *Eisner*.

POINT II.

A dividend paid out of corporate profits accumulated prior to March 1, 1913, is not taxable income of the stockholder within the meaning of the Income Tax Law of 1913.

Upon the facts alleged in the complaint and admitted by the demurrer the question of law above stated is squarely presented. The corporate earnings and profits realized subsequently to March 1, 1913, available for the payment of the dividend did not exceed the $4.12 of the dividend per share which the plaintiff had voluntarily returned for taxation and upon which the tax had been paid. The assessment in suit was based upon the remainder of said dividend, which was paid entirely out of profits accumulated by the corporation prior to March 1, 1913, and constituted a part of the $167.46 of capital and surplus on that date applicable to and represented by each share of the common stock.

The dividend having been declared and paid in 1914, the question of law arises under the Income Tax Law of 1913, then in force, being Section II of the tariff and revenue Act of October 3, 1913, Chapter 16, [38 Stats. 114, 166].

The decisions of the question by the lower courts

represent a fairly equal division of opinion. It has been ruled against the tax by the Circuit Court of Appeals for the Eighth Circuit in *Lynch* v. *Turrish*, 236 Fed. 653 and *Lynch* v. *Hornby*, 236 Fed. 661, affirming decisions of the District Court in the Minnesota District; by the District Court for the Western District of Pennsylvania in *Gulf Oil Corporation* v. *Lewellyn*, 242 Fed. 709; and by the District Court for the Colorado District in *Union Pacific Coal Company* v. *Skinner*, decided March 2, 1917, unreported. On the other hand the question has been ruled in favor of the tax by the District Court for the Southern District of New York in the present case and in *Southern Pacific Company* v. *Lowe*, 238 Fed. 847; and by the Circuit Court of Appeals for the Third Circuit in *Llewellyn* v. *Gulf Oil Corporation*, 245 Fed. 1, reversing the decision of the District Court in the case of the same name cited above. All of the foregoing cases, except *Lewellyn* v. *Gulf Oil Corporation* and *Union Pacific Coal Company* v. *Skinner*, are now before this Court.

I.

Adequately and fairly construed, the Act purports to tax dividend receipts only to the extent that they constitute gains, profits or income arising or accruing after March 1, 1913, and a dividend paid out of corporate profits accumulated prior to March 1, 1913, is not within the plain intendment of these terms.

The subject of the taxes imposed by this statute is *net income arising or accruing annually from and*

after March 1, 1913. The Act does not purport to be applicable to all receipts, without regard to whether they are income or the proceeds of conversion of capital. It does not purport to be applicable even to all income but only to income which arose or accrued after March 1, 1913. No other meaning can be attributed to the act except by ignoring terms which have a direct and material pertinency.

The tax liability in the case of individuals is created by subsection A, subdivision 1 of which imposes the normal tax and subdivision 2 the additional tax commonly known as the surtax. Subdivision 1 provides: "That there shall be levied, assessed, collected "and paid *annually upon the entire net income arising "or accruing from all sources in the preceding calendar "year* to every citizen of the United States, whether re- "siding at home or abroad, and to every person resid- "ing in the United States, though not a citizen thereof, "a tax of 1 per centum per annum upon such income, "except as hereinafter provided." This is the fundamental declaration of the tax liability. As such it declares the rule by which the subsequent and subordinate provisions of the Act must be construed. There are no subsequent provisions which conflict with this fundamental rule. There are subsequent provisions concerning details of the application and administration of the law which refer to the subject-matter of the tax briefly as "net income" but these provisions, read as they must be in the light of the fundamental rule, create no conflict or inconsistency by reason of their omission

of the qualifying phrase as to the annual arising or accruing of such income.

The tax liability is further limited by subsection D, wherein, following the provisions for various exemptions of and deductions from income in subsections B and C, it is provided: "The said tax shall be "computed upon the remainder of said net income of "each person subject thereto, accruing during each pre- "ceding calendar year ending December thirty-first: "Provided, however, That for the year ending Decem- "ber thirty-first nineteen hundred and thirteen, said "tax shall be computed on the net income accruing from "*March first to December thirty-first nineteen hundred* "*and thirteen,* both dates inclusive, after deducting five- "sixths only of the specific exemptions and deductions "herein provided for." There is no phrase or word in the Act which detracts in the slightest degree from the limitation just quoted of taxable income to that accrued after March 1, 1913.

Since dividend income is exempted from the imposition of the normal tax by the last proviso in subsection D, the present case concerns only the surtax imposed by subdivision 2 of subsection A, which provides: "In "addition to the income tax provided under this section "(herein referred to as the normal income tax) there "shall be levied, assessed and collected upon the net "income of every individual an additional income tax "(herein referred to as the additional tax) of 1 per "centum per annum upon the amount by which the "total net income exceeds $20,000 and does not exceed

"$50,000," and so on in increased percentages up to the final bracket of 6 per cent. upon the amount by which the total net income exceeds $500,000. This subdivision contains also a provision, which will be quoted and considered later in this brief, making undivided corporate profits, under certain conditions, a part of the taxable income of stockholders subject to the surtax. The subject of the surtax liability is the same annually arising and accruing net income which is the subject of the normal tax, except that by virtue of certain express provisions dividend income is withdrawn from the operation of the normal tax and undivided corporate profits are added to the income subject to surtax. Subdivision 2 uses only the brief expression "net income" in referring to the subject of the surtax. But the surtax subdivision cannot stand alone as a separate and distinct tax law, complete in itself; practically all of the subsequent subsections of the law are applicable to it and necessary to its administration. Aside from the natural and necessary inference that the declaration in subdivision 1 of the fundamental basis of the tax liability is applicable to subdivision 2, it is an express provision of the latter subdivision that: "All the provisions of this section "relating to individuals who are to be chargeable with "the normal income tax, so far as they are applicable "and are not inconsistent with this subdivision of para-"graph A, shall apply to the levy, assessment and col-"lection of the additional tax imposed under this sec-"tion." This rather inexact provision was perfected

in the 1916 revision [Act of September 8, 1916] to read: "All the provisions of this title relating to the "normal tax on individuals, so far as they are applicable "and not inconsistent with this subdivision and sec- "tion 3, shall apply to the imposition, levy, assessment "and collection of the additional tax imposed under "this subdivision". And, further, it cannot be doubted that this surtax subdivision, equally with the normal tax subdivision, is governed by the limitation in subsection D to the effect that the tax shall be computed upon *net income accruing after March 1, 1913.*

The terms "arising" and "accruing" have a wide diversity of use and have frequently been the subject of judicial definition. [See definitions in Vol. 1 Corpus Juris, p. 732 *et seq*]. But undoubtedly the best light upon the sense in which they are used in this statute is furnished by the report of the Ways and Means Committee of the House of Representatives accompanying the bill afterwards enacted as the revised income tax law of September 8, 1916. This report [see Appendix to this brief, p. 43] contained the following: "The present law requires that the income tax "shall be levied on the accrued basis. As two systems "of bookkeeping are in use in the United States, one "based on the cash or receipt basis and the other on "the accrual basis, it was deemed advisable to provide "in the proposed measure that an individual or cor- "poration may make return of income on either the "cash or accrued basis, if the basis selected clearly re- "flects the income". In accordance with this statement,

the 1916 Act, in Section 1, subdivision (a), omitted the expression "arising or accruing", and, in lieu thereof, provided for the levy of the tax upon the "en- "tire net income *received* in the preceding calendar "year" etc. and inserted as Section 8, subdivision (g), a new provision to the effect that an individual keeping accounts upon any basis other than that of actual receipts and disbursements may make his return and pay the tax on the basis upon which his accounts are kept. It thus appears that the expression "arising or accruing" in the 1913 Act was understood to provide for assessment of income on the basis of its accrual as distinguished from its actual receipt. It is clear, therefore, that under the 1913 Act income is "arising or accruing" when it is in the process of being earned or of coming into existence as a right or property interest of the beneficiary—that its accrual is not equivalent to its receipt.

The description of the subject of the tax liability is elaborated in subsection B of the 1913 Act which provides: "That, subject only to such exemptions and de- "ductions as are hereinafter allowed, the net income of "a taxable person shall include *gains, profits and in- "come derived* from salaries, wages, or compensation "for personal service of whatever kind in whatever "form paid, or from professions, vocations, businesses, "trade, commerce, or sales, or dealings in property, "whether real or personal, growing out of the owner- "ship or use of or interest in real or personal property, "*also from interest, rent, dividends, securities* or the

"transaction of any lawful business carried on for gain "or profit, or gains or profits and income derived from "any source whatever, including the income from but "not the value of property acquired by gift, bequest, "devise or descent".

The decisions of the lower courts which have sustained the taxation of dividends, regardless of when earned, proceed upon the theory that the statute declares all dividend receipts to be taxable income. But the statute does not so declare. There is nothing peculiar about the treatment of dividends in subsection B. They are named with salaries, rents, interest, etc., merely as sources of income. It is declared that "net income" shall include "gains, profits and income *"derived from"* salaries, dividends, etc. This subsection is a more or less comprehensive catalogue or specification of income sources. But there is no declaration that all receipts from such sources shall constitute taxable income. Subsection B is subordinate to the fundamental rule as to the basis of the tax liability declared in subsection A; and so the "net income" to which it refers is the "net income arising or accruing * * * in the preceding calendar year". It is also governed by the provision of subsection D limiting the liability to net income accruing after March 1, 1913. Therefore, subsection B in effect reads: *The net income of a taxable person shall include gains, profits and income, arising or accruing in the preceding calendar year and after March 1, 1913, derived from salaries * * interest, rent, dividends, etc.*

The expression "gains, profits and income *derived "from* salaries * * * interest, rent, dividends," etc., was used advisedly and deliberately. Not all receipts on such accounts constitute income. Perhaps the most common illustration of this proposition occurs in the case of trading in bonds, at an agreed price plus accrued interest. The purchaser of a $1,000 bond bearing 6 per cent. interest, at par and accrued interest, midway between semi-annual interest dates, would pay to the seller $1,015. This whole payment would represent an investment of the purchaser's principal. Three months later he would receive from the debtor corporation an interest payment of $30, but of this $30 only $15 would represent income of the purchaser, the remaining $15 being a proper credit to his investment account to reduce the principal of his investment to $1,000. The purchaser of stock just prior to the vesting of a dividend actually buys the whole amount of the dividend, even though the dividend be not made a separate factor in the purchase price, and upon the vesting of the dividend the market price of the stock, then selling ex-dividend, is less than its former price by approximately or exactly the amount of the dividend; therefore, such purchaser, if guided by sound accounting principles and common sense, would treat the dividend received by him as a partial return of principal and credit it to his investment rather than to his income account. A liquidation dividend upon the dissolution of a corporation, or a partial liquidation dividend incident to a reduction of capital stock, constitutes

in every case a return of principal, wholly or in part, to the stockholder. Since this enactment imposed taxes upon a subject-matter not previously taxed for many years, and it was adopted, necessarily we believe, as the policy of the legislation that only income arising and accruing after March 1, 1913, should be subject to the tax, it was appropriate that even receipts of such a strictly income character as those from salaries and wages should not be covered by the law except to the extent that were earned after March 1, 1913. For example, salary earned by an employee for services rendered prior to March 1, 1913, would constitute his income for the period in which it was earned although the payment might not be received until after March 1. It was in consideration of such matters as the foregoing that the framers of the law employed in subsection B the expression, "*gains, profits and income derived from* salaries, * * * interest, rents, "dividends," etc., to avoid the use of language so broad as to include receipts from the specified sources which might in a given case constitute a return of principal, or so broad as to include, in conflict with the limitation in subsection D, *delayed* receipts of gains, profits and income which *arose or accrued* before the effective date of the tax.

The meaning and purpose of the pertinent terms of the Act are therefore clear. The application of these terms in the case of receipts from such sources as salaries, rent and interest is also clear. It only remains to consider whether there is some peculiarity

inherent in dividends which prevents the same application to them of the terms of the Act. It is urged as an obstacle to such application that a dividend is not a debt of the corporation or a right of the stockholder until its declaration and that the stockholder has nothing arising or accruing until the dividend is received, or at any rate declared, so that the accruing and receipt of the dividend income are simultaneous. This theory considers the corporation and the stockholder as distinct and unrelated parties; in effect it considers a dividend as a pure gratuity. But the stockholder certainly cannot be theorized into a worse position than an individual deriving a profit from the sale of property. It has never been the theory under this Act that a profit derived from a sale of property acquired prior to March 1, 1913, was wholly profit of the year when sold. The revenue authorities uniformly prorated such a profit and held for taxation only the proportion applicable after March 1, 1913, thereby recognizing the profit *received* upon the sale as *arising* and *accruing* to the owner gradually throughout the period of ownership. [Income Tax Regulations No. 33 issued January 5, 1914, Art. 109; Treasury Decision No. 2090, December 14, 1914, under heading: "Profit from sale of real estate"]. The corporation and the stockholder are not distinct and unrelated parties for the purposes of this law. Notwithstanding the stockholder cannot at will withdraw the corporate profits, his interest as a co-owner of the corporate business and property cannot be ignored. A profit arises or accrues to his investment in the corporation by

accumulation of corporate profits as fully as a profit arises or accrues to the owner of real estate through its gradual enhancement of value. It is true that until a dividend has been declared it is generally impracticable for the stockholder to make any credit to his income account on account of income arising or accruing. But when the dividend has been declared there is no difficulty or impropriety in determining the periods of accrual of the income *"derived from"* or represented by such dividend. This is recognized by Section 31, subdivision (b), added to the income tax law by Section 1211 of the revenue Act of October 3, 1917, whereby it is provided that corporate dividends paid in 1917 and thereafter shall be deemed paid out of the most recently accumulated undivided profits or surplus of the corporation and shall be taxed as income of the stockholder at the tax rates in effect in the various years in which such profits or surplus were accumulated by the corporation. It is true that the stockholder has no legal title to the corporate assets representing the undistributed profits and that he cannot obtain the profits directly from the corporation until the directors see fit to declare a dividend. It is equally true that he has no legal title to the corporate assets representing the capital underlying each of his shares and that he cannot obtain a return of this capital directly from the corporation until the corporation shall have been dissolved and liquidated. But his property interest in the accumulated profits is identical with his property interest in the capital. Each share of his stock represents a proportionate interest in the capital and accu-

mulated profits. The increase of accumulated corporate profits enures to the benefit of the stockholders and to no one else. The stockholder may secure the profit underlying his shares by a sale if he is unwilling to await the declaration of dividends. It must be concluded therefore that dividends are susceptible of precisely the same application of the Act as interest, rents and salaries, and that dividend receipts are taxable only to the extent that they represent a gain or profit arising or accruing to the stockholder after March 1, 1913, that is only to the extent that they distribute profits which had not already been accumulated by the corporation and represented by its shares on or before that date.

2.

The foregoing construction is emphasized by the recognition accorded by the Act to undistributed corporate profits as taxable income of the stockholder.

Subdivision 2 of subsection A, imposing supertaxes, provides: "For the purpose of this additional tax the "taxable income of any individual shall embrace the "share to which he would be entitled of the gains, and "profits, if divided or distributed, whether divided or "distributed or not, of all corporations, joint stock com-"panies, or associations however created or organized, "formed or fraudulently availed of for the purpose of "preventing the imposition of such tax through the "medium of permitting such gains and profits to ac-"cumulate instead of being divided or distributed".

This provision is a positive and express recognition by Congress of the corporate gains and profits as income of the stockholder even though undistributed, although it was the legislative policy not to subject them to taxation unless withheld from distribution for the purpose of evading their taxation as dividend income. It is, therefore, a positive refutation of any contention that all dividend receipts constitute income within the meaning of this statute, because of a supposed want of interest of the stockholder in the corporate earnings prior to their distribution.

It is assumed that no contention will be made that under this surtax subdivision there was an intention to tax as income of the stockholder undistributed corporate profits already accumulated on March 1, 1913. Aside from the question of Constitutional power, any such contention is conclusively answered by the general limitation in subsection D that the tax shall be computed upon the net income accruing after March 1, 1913, which general limitation is equally applicable to the normal tax and the surtaxes.

The corporate profits, being recognized by the statute as taxable income of the stockholder, even though undistributed, it follows that their distribution by a dividend declaration does not within the meaning of this law *create* income of the stockholder, but merely constitutes a realization of income already accrued. Since, then, the stockholder's income arises or accrues when the profit is realized and accumulated by the corporation, and since for the purpose of the imposition of the

tax on undistributed corporate profits as income of the stockholder, the March 1, 1913, limitation undoubtedly applies, it attributes an extraordinary inconsistency to Congress to contend that for the purpose of the imposition of the tax upon corporate profits when distributed to the stockholder the same limitation was not intended to apply. Or, to state the same proposition in a different way: The statute recognizes the accumulated corporate profits as income of the stockholder, and imposes the tax thereon against the stockholder either (1) in the form of undistributed corporate profits, certain conditions existing, or (2) in the form of distributed profits received by the stockholder as a dividend; and it would be an impossible construction that the intervention of the dividend declaration, rendering applicable the taxation in the second of these forms, could release the taxation from the limitation excluding the corporate profits accumulated prior to March 1, 1913, applicable in the absence of a dividend declaration.

3.

The foregoing construction is directly supported by a decision of this Court construing a dividend provision of the Civil War Income Tax Law.

Under Section 122 of the Act of June 30, 1864, Chapter 173 [13 Stats. 223, 284] a litigation arose concerning an extraordinary dividend in scrip issued by

the New York Central Railroad Company, which was settled by this Court in *Bailey* v. *New York Central R. R. Co.*, 106 U. S. 109.

The facts of that case were that the Railroad Company issued in 1868 to stockholders scrip certificates of a nominal or par value equal to 80 per cent. of the capital stock, evidencing the proportionate interests of the holders in corporate profits invested during the period of 15 years from 1853 in improvements and additional property; that an income tax under the aforesaid revenue act was imposed on the entire par amount of said certificates as a scrip dividend; that nine-fifteenths of said tax was thereafter remitted by the Commissioner as the proportion of the dividend represented by the 9 years of the accumulation period prior to the incidence of the first income tax law (that of 1862); and that the Railroad Company sued the collector for the recovery of whole tax collected.

The law governing the case was as follows:

> "Section 122. *And be it further enacted,* That "any railroad, canal, turnpike, canal navigation, or "slackwater company indebted for any money for "which bonds or other evidence of indebtedness "have been issued, payable in one or more years "after date, upon which interest is stipulated to "be paid, or coupons representing the interest, or any such company that may have *declared any "dividend in scrip,* or money due or payable *to its "stockholders, as part of the earnings, profits, in-"come, or gains of such company,* and all profits "of such company carried to the account of any

"fund, or used for construction, *shall be subject to "and pay a duty of five per centum on the amount of "all such interest, or coupons, dividends,* or profits, "whenever the same shall be payable; and said "companies are hereby authorized to deduct and "withhold from all payments, on account of any "interest, or coupons and dividends due and pay- "able as aforesaid, the duty of five per centum"; etc.

On the second trial of the case, the judgment entered on the first trial having been reversed, the Railroad Company undertook to prove that the dividend in fact represented only a limited amount of profits subsequent to September 1, 1862. The jury found that said profits after September 1, 1862, were some five million less than the amount ascertained by the Commissioner's method of uniform apportionment by years, and judgment for the Railroad Company resulted in accordance therewith. The question on the appeal reported in 106 U. S. 109 was based upon the Government's exception to the charge of the trial court that it was competent for the railroad company to show what amount of the earnings of the company accruing from 1862 to 1868 was represented by the scrip certificates and that this amount alone was subject to the tax, and to the exception of the Government to the refusal of the trial court to charge that the scrip certificates were conclusive as to the amount of the dividend subject to taxation, in other words, that the dividend was taxable upon its full nominal or par amount.

This Court sustained the charge of the trial judge and affirmed the judgment. It was said [p. 114]:

> "It should be borne in mind, in the first place, "that the tax provided for in this section is an an- "nual income tax, and its subject is the interest "paid and profits earned by the company for each "year, and year by year; and that both by the ex- "press letter of the law, and its necessary impli- "cations, the tax is not laid on any of these funds "which came into being before the time prescribed "in the act."

Section 122 of the Act of 1864 was part of the individual income tax provisions beginning with Section 116 of that Act, which section imposed a tax upon the annual gains, profits or income of every resident or citizen "whether derived from any kind of property, rents, interest, dividends, salaries," etc. The tax under Section 122 was levied upon the profits of the corporation, determined, however, as a matter of certainty and convenience by reference to the corporation's disposition of such profits, namely, by the amount of dividend and interest payments, the amounts carried to any fund, or the amounts used for construction. The tax paid by the corporation was authorized to be deducted from any dividend or interest payments, so that by the express terms of the section, as well as from the sections with which it was grouped, it would appear that the tax was imposed upon such profits as the stockholders' and bondholders' income. It had been generally so treated in the earlier decisions of this Court but one

decision had raised some doubt as to this conclusion. It was said in the opinion in the *Bailey* case [106 U. S., at p. 116] that, while there had been a difference of opinion as to whether the tax was upon the corporation or upon the income of the stockholders and bondholders, it was immaterial for the purposes of the case then before the Court which of these views of the tax was adopted.

The subject of the tax in the *Bailey* case specifically included *"any dividend in scrip"* and the tax was imposed upon the dividend *"whenever the same shall be payable."* These terms afforded much stronger ground for the Government's contention that the dividend as such was the subject of the tax and that any showing as to when the profits represented by the dividends accrued to the corporation was inadmissible, than is afforded by the terms of the Act of 1913. Further, the Act of 1864, unlike the Act of 1913, contained no express provision limiting taxable income to that accruing after the date from which the income tax law became effective. Nevertheless this Court held that in view of the provisions for the *annual* accrual of the tax liability "the express letter of the law," as well as its necessary implications, excluded from the tax liability funds which came into existence prior to the operation of the income tax law.

From the reported opinion in the *Bailey* case it might be thought that the principal contention of the Railroad Company was that the scrip dividend repre-

sented profits which had previously been taxed under the same section. But from an inspection of the record and briefs therein it appears that the principal contention of the Railroad Company was that it was entitled to show the amount of corporate profits realized after September 1, 1862, which the dividend represented, and that it advanced only as a secondary argument against the conclusiveness of the scrip certificates the proposition that in any event it was competent to go behind the certificates to show to what extent they represented profits which had already paid the tax. It does not appear that this latter proposition had been one of the grounds of recovery in the trial court. This proposition was introduced into the case at so late a stage that it was not referred to in the principal briefs for the Government but was first mentioned, with an admission of surprise, in the reply brief of the Solicitor General [at p. 3 thereof].

It is submitted that the question primarily involved and decided in the *Bailey* case is so closely analogous to the question in the present case that said decision constitutes a direct precedent for this case.

4.

The foregoing construction is conclusively established by the legislative history of the amendment enacted in the revision of the Income Tax Law in 1916 whereby taxable dividend income was expressly limited to dividends out of corporate profits accrued after March 1, 1913.

The Income Tax Law of September 8, 1916, [39 Stats. 756] contains in its Section 2 (*a*) the same specification or catalogue of sources of income as that quoted above on p. 13 of this brief from subsection B of the 1913 act, but adds thereto a proviso that the term "dividends" shall be held to mean any distribution to stockholders by a corporation out of its earnings or profits accrued since March 1, 1913. By the addition of this proviso the controversy which had arisen under the 1913 Act as to the tax status of dividends was settled for the purposes of future taxation, and settled in conformity to the construction for which we contend in the present case. But the amendment of 1916 was not retroactive. The question is thus presented whether the express limitation inserted in the 1916 act, was intended as a change of the tax liability of dividend income as it existed under the 1913 act, wherein no such express limitation occurred, or was intended as a legislative interpretation of the 1913 pro-

vision. We believe that the proviso added by the 1916 revision was legislative interpretation and was intended to be merely declaratory of the previous law.

It is unnecessary to resort to presumptions in determining this question of intent. The proceedings in Congress attending the 1916 revision establish affirmatively that no change in the law as to the tax liability of dividends was intended, but that the express language added by the proviso was intended merely to clarify and confirm. For this purpose only such reference will be made to committee reports and congressional proceedings as has been sanctioned by this court for use in aid of statutory construction. *Holy Trinity Church* v. *United States,* 143 U. S. 457, 464, 465. *Blake* v. *National Bank,* 23 Wall. 307, 317, 318 (referred to with approval in *Caminetti* v. *United States, 242 U. S.* 470, 490). *Binns* v. *United States,* 194 U. S. 486, 495. *St. Louis & Iron Mountain Ry.* v. *Craft,* 237 U. S. 648, 661. *Lapina* v. *Williams,* 232 U. S. 78, 89.

The 1916 revision was embodied in the revenue bill designated as H. R. 16763 of the 64th Congress, 1st Session. The bill was reported to the House of Representatives by the Committee on Ways and Means on July 5, 1916. The report of said Committee accompanying the bill [Report No. 922] in so far as it refers to the income tax provisions of the bill is printed in the Appendix to this brief. The bill as so reported

to the House contained the specification or catalogue of income sources copied without change from subsection B of the 1913 act, with a new proviso added thereto as follows:

> "Provided, That the term 'dividends' as used "in this title shall be held to mean any distribu- "tion made or ordered to be made by a corpora- "tion out of its earnings or profits and payable "to its shareholders, whether in cash or in stock "of the corporation."

To this the Committee added as a committee amendment, at the outset of the consideration of the measure in the House, the following words: "which stock dividend shall be considered income to the amount of its cash value." [See Congressional Record, 64th Congress, 1st Session, July 10, 1917, p. 12329.] The bill passed the House on July 10, 1917, in the form proposed by the Committee and on the following day was referred by the Senate to its Finance Committee.

On August 16, 1917, the bill was favorably reported by the Finance Committee with a number of amendments. Among the Finance Committee's amendments were four affecting the new proviso of the House Bill concerning dividends. The proviso, with the Senate Committee amendments to the House provision shown by underscoring and by brackets, was as follows:

"Provided, That the term 'dividends 'as used "in this title shall be held to mean any distribu- "tion made or ordered to be made by a corpora- "tion (Amendment 6), *joint stock company, as- "sociation, or insurance company,* out of its earn- "ings or profits (Amendment 7) *accrued since "March first, nineteen hundred and thirteen,* "and payable to its shareholders, whether in cash "or in stock of the corporation (Amendment 8), *"joint stock company, association, or insurance "company,* which stock dividend shall be consid- "ered income (Amendment 9) [to the amount "of its cash value]."

The report of the Senate Finance Committee accompanying the bill in so far as the same refers to the income tax provisions is printed as an Appendix to this brief. The report enumerated a few amendments of the House bill, without specific mention of those quoted above, and said it had added a number of amendments "for the purpose of simplifying and clarifying the administrative features of the Act."

The amendments of the Senate Committee to the above proviso were accepted by the Senate without debate [Congressional Record, 64th Congress, 1st Session, August 26, 1917, p. 15449].

The bill thereupon went to conference. The conference recommended the acceptance by the House of Senate Amendments numbered 6, 7 and 8 and that the Senate recede from its 9th amendment, and the recommendations were adopted, without debate, by both branches [See Conference Report printed in full in the Congressional Record, 64th Congress, 1st Session, Sep-

tember 7, 1916, pp. 16421 to 16428, and pp. 16455 to 16462]. The conferees on the part of the Senate made no explanatory statement accompanying the conference report, but the conferees on the part of the House [Congressmen Kitchin, Rainey, Dixon and Hull] included in their report an explanatory statement of the recommendations of the conference [see above cited Congressional Record of September 7, 1916, pp. 16462 to 16467]. Their explanation concerning the amendments to the dividend proviso was as follows [p. 16462]:

> "Amendments Nos. 4, 5, *6, 7 and 8: These "amendments are merely clerical changes,* and "the House recedes.
>
> "Amendment No. 9: The House Bill pro- "vided that stock dividends made out of earnings "or profits should be considered income to the "amount of its cash value, and the Senate recedes."

To summarize the foregoing legislative history: The House Committee in its original report of the bill [Appendix, p. 42] characterized the bill, in respect of the income tax provisions, as being, aside from increases in the tax rates and a few changes in the law specifically mentioned, a re-arrangement and re-paragraphing of the 1913 Act. No mention in this report was made of the new proviso as to dividend income. It is not, however, for the purposes of the present case important to show that the proviso originated by the House was not intended as a change of the existing law, since the original form of the proviso contained nothing affecting the present question but merely embodied an express

provision as to *stock* dividends. The language which affects the present case was added by the Senate Committee as its amendment No. 7, to wit: "accrued since March 1, 1913," thereby expressly excluding from the taxable dividend income, both as to cash dividends and stock dividends, whatever was paid out of corporate profits earned before March 1, 1913. The report of the Senate Committee [Appendix, p. 44] stated that the Committee had made "very few changes in the Income Tax Law" and proceeded to specify the amendments suggested with reference to the income tax title of the bill. The amendments so specified do not concern the definition of dividends but the amendments to this provision were evidently included in the general reference to a number of amendments made "for the purpose of simplifying and clarifying the administrative features of the Act." The inference therefore is that the Senate Committee, being the originators of the express exclusion of dividend income earned prior to March 1, 1913, considered the amendment unimportant and merely declaratory. Certainly there is no indication that the Senate Committee considered that any change had been effected in the taxable status of dividend income. The fact that the Senate Committee amendment was not deemed of sufficient importance to call for inquiry or discussion in the course of the careful and prolonged consideration given the measure in the Senate is also significant. But if all the proceedings and documents prior to the Conference Report be considered merely negative, it still remains that the intention with respect to this amendment is expressly stated by the House con-

ferees. *They characterized the addition of the words "accrued after March 1, 1913" as a clerical change.* This characterization is convincing and controlling. It is not an expression of opinion by an individual member of Congress in debate; it is an official explanation by the conferees appointed on the part of the House to consider the various provisions of the bill on which the two branches were in disagreement. It represents their understanding of the Senate amendments and was an official representation by them to the House, upon which the House acted and which it accepted, that the additional words inserted by the Senate constituted a mere clerical change, that is, did not effect any change in the provision as passed by the House. Since the proviso as originally adopted by the House obviously made no change in the pre-existing taxable status of income, other than possibly *stock* dividends, it follows that the clerical changes made by the Senate therein did not change but merely confirmed the taxable status of dividend income as it existed under the 1913 Act.

POINT III.

The taxation against stockholders of corporate profits accumulated before the adoption of the Sixteenth Amendment to the Constitution would constitute direct taxation which it is not within the power of Congress to levy without apportionment.

The Income Tax Law of 1913 contained no provision for the apportionment of the taxes thereby imposed among the several States or according to population as

required in the case of direct taxes by the 2nd and 9th sections of Article I of the Constitution.

Income derived from investments in stocks was expressly included in *Pollock* v. *The Farmers Loan & Trust Co.*, 158 U. S. 601, 618, as within the final ruling of that case, on the rehearing, that taxation of income derived from invested personal property was direct taxation subject to the Constitutional rule of apportionment. It will be assumed that this proposition need not be re-argued, but will be accepted by the Court as an established premise from which to pursue the present inquiry. It was the view of this Court, expressed in *Brushaber* vs. *Union Pacific R. R. Co.*, 240 U. S. 1, 19, that the Sixteenth Amendment contains nothing repudiating or challenging the ruling in the *Pollock* case and that the purpose of the Amendment was not to change the existing interpretation, except to the extent necessary to accomplish the result intended.

Under the decision in the *Pollock* case and until the adoption of the Sixteenth Amendment, direct taxes which could be levied only by the apportionment rule, included the taxation of investments in stocks or other forms of personal property through the taxation of the income derived from such investments. Therefore, prior to the adoption of the Sixteenth Amendment the tax involved in the present case would have been void for want of apportionment in the levy. The rule of the *Pollock* case is equally applicable to the taxation of

the income from a stock investment when received in the form of a dividend and when accruing to the stockholder by the realization and accumulation of profits by the corporation and remaining in the corporate treasury undistributed. The power was possessed by Congress to tax such undistributed corporate profits as income of the stockholder. *Collector* v. *Hubbard*, 12 Wall. 1. The contention would be untenable that taxation of corporate profits as income of the stockholder could be direct taxation by the application of the rule of the *Pollock* case when the levy was upon the dividend, and an excise tax, not requiring apportionment, when the levy was upon the undistributed profits.

The Sixteenth Amendment provided: "The Con-"gress shall have power to lay and collect taxes on in-"comes, from whatever source derived, without ap-"portionment among the several States, and without "regard to any census or enumeration".

The Constitutional requirement of apportionment in the levying of *direct* taxes was not abolished by the Sixteenth Amendment. The purpose of the Amendment, as held by this court in *Brushaber* vs. *Union Pacific R. R. Co., supra,* was, as stated at page 18, "to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived." The effect of the Amendment is, therefore, that a tax on income from an investment in real or personal property is no longer to be regarded

as a direct tax as being equivalent to a levy upon the investment itself.

The first question presented is whether the Sixteenth Amendment was retroactive, whether under its operation income already accrued to and within the actual or potential possession and enjoyment of a stockholder, and which could theretofore have been taxed only subject to the rule of apportionment, immediately thereafter became liable to retroactive taxation by a different rule, that is, without apportionment. The question has never been adjudicated by this Court. It has been impliedly recognized in the various income tax laws enacted since the adoption of the Sixteenth Amendment that the Amendment was not retroactive. Argument would seem to be unnecessary to establish the propriety of a negative answer to the proposition. The consequences of a retroactive application of the Amendment would be prohibitive, since, if it authorized the taxation without apportionment of *any* income accrued prior to its adoption, such authority would extend to *all* income previously accrued and, the greater part of the wealth of the country being the accumulation of income, gains and profits of the past, it would result that the very accumulations of property which the Constitutional rule of apportionment was designed to safeguard could be assessed in the form of income taxation without apportionment.

In the second place, assuming that the Sixteenth Amendment is not accorded retroactivity, the question

arises as to the meaning of the term "incomes" in the Sixteenth Amendment,—whether under the facts alleged in the complaint and admitted by the demurrer the subject-matter of the tax in this case was not income of the plaintiff before the adoption of the Amendment rather than thereafter. The portion of the dividend upon which the additional assessment against plaintiff was made was paid entirely out of corporate profits accumulated prior to March 1, 1913. These profits, as fully in all respects as his share of the capital of the corporation, were within the potential possession and enjoyment of the plaintiff when the Sixteenth Amendment was adopted. He could have realized and reduced to possession his share of both capital and profits by a sale. If the corporation had been dissolved on March 1, 1913, and liquidated without realizing further profits, the subsequent receipt by plaintiff of his share of the capital and accumulated profits through a liquidation dividend would not be claimed to constitute *income* taxable according to the rule of the Sixteenth Amendment. What actually happened was a partial liquidation—a payment to plaintiff of some $29. on account of the $67. per share of the corporate profits accumulated and on hand on March 1, 1913. The legal effect is the same *pro tanto* as that of a complete and final corporate liquidation. Whatever the taxpayer possessed at the time of the adoption of the Amendment as a part of his property interest or investment, whether a part of his original principal or an augmentation

thereto, constituted a part of his principal for the purposes of future taxation, and a subsequent transmutation of the form of this principal resulting in no increase of his total wealth cannot be deemed income subject to a new rule of taxation authorized for the future.

The corporate profits as they accrued were unquestionably subject to taxation as income prior to March 1, 1913, provided only that the rule of apportionment was observed. Undistributed corporate profits have been recognized as taxable income of the stockholder in income tax acts enacted prior to the *Pollock* case (Act of June 30, 1864, Secs. 117, 120, 122, 13 Stats. 282 to 284; Act of March 3, 1865, 13 Stats. at p. 480; Act of March 2, 1867, Sec. 13, 14 Stats. at p. 478; Act of July 14, 1870, Secs. 7 and 15, 16 Stats. at pp. 258, 260), as well as in those recently enacted. These considerations are conclusive that the term "incomes" in the Sixteenth Amendment comprehended such profits. Therefore, unless the Amendment was intended to be retroactive, it cannot be construed as applicable to such income already accrued at the time of its adoption, whether in its form of undistributed profits or in the transmuted form of a dividend.

CONCLUSION.

That part of the judgment dismissing the first cause of action should be reversed, and the demurrer to the first cause of action overruled, or the judgment below as a whole may be reversed and the demurrer to the first cause of action overruled.

The judgment under review contains two clauses, viz.: (1) that the first cause of action, which was for the recovery of the whole of the tax and interest collected from the plaintiff, be dismissed, the demurrer thereto having been sustained, and (2) that the plaintiff recover of the defendant, under the second cause of action, the total sum, including interest, of $191.39 (Record, pp. 11, 12). The writ of error is confined to the judgment upon the first cause of action. The partial recovery sought and awarded under the second cause of action was not of course additional to the full recovery prayed in the first cause of action, but merely alternative thereto. The prayer of the complaint (Record, p. 7) was "for judgment for the sum of "$1498.10 under the first cause of action herein, or, "*if said first cause of action be not sustained* for the "sum of $363.11 under the second cause of action here-"in, and in either case with interest from the 16th day "of May 1917." A reversal of that part of the judgment which dismisses the first cause of action should therefore supersede the remaining portion of the judgment awarding plaintiff a partial recovery. The judg-

ment of this Court may be confined to the reversal of the judgment in so far as it dismisses the first cause of action, leaving to the District Court all further proceedings necessary. Or, in the interest of simplifying the procedure in the District Court which will result from this Court's mandate, it is believed that this Court's judgment may properly be a reversal of the entire judgment below.

Respectfully submitted,

HENRY W. CLARK,
Of Counsel for Plaintiff-In-Error.

Dated February, 1918.

APPENDIX.

Extract from Report of Committee on Ways and Means.

64th Congress 1st Session. } HOUSE OF REPRESENTATIVES. { No. 922 Report

TO INCREASE THE REVENUE AND FOR OTHER PURPOSES.

July 5, 1916—Committed to the Committee of the Whole House on the state of the Union and ordered to be printed.

MR. KITCHIN, from the Committee on Ways and Means, submitted the following

REPORT

(To accompany H. R. 16763).

The Committee on Ways and Means, to whom was referred the bill (H. R. 16763), to increase the revenue, and for other purposes, having had the same under consideration, report it back to the House without amendment and recommend that the bill do pass.

* * * * * *
* * * * * *

THE PROPOSED REVENUE MEASURE.

This measure proposes two new sources of revenue, namely, an inheritance or estate tax and a tax upon the manufacture of munitions of war.

The necessary additional revenue is to be raised in the following manner:

(1) By increasing the present income-tax rates; (2) by levying an estate tax; (3) by levying a tax upon the manufacture of munitions of war; and (4) by reenacting certain of the special taxes provided in the emergency revenue act of October 22, 1914.

Income Tax.

The present income-tax law has given general satisfaction. The practical administration of the law, however, has suggested changes or modifications of some of the minor and administrative provisions, the effect of which will be both to clarify and better adjust such provisions to some of our complicated business conditions and to facilitate the administration of the law. In a few instances some rearrangements of kindred provisions have been effected in order that they might be assembled under their respective heads, with the result that the various provisions of the law now stands in their logical order. For the sake of ready and convenient reference to any provision in the law in the future, it was considered wise to reparagraph the same. The foregoing changes have not disturbed the chief or fundamental features of the present income-tax law.

The committee deemed it advisable to reenact the law in the proposed amended form, with the resulting repeal of the law as originally enacted.

This bill proposes an increase in the normal tax on incomes and the tax on corporations from the present rate of 1 per cent. to 2 per cent. The present law imposes the following additional tax rates upon net incomes of individuals:

* * * * * *

The proposed bill imposes the following additional tax rates upon net incomes of individuals:

* * * * * *

This bill leaves the income exemption at $3,000 for unmarried persons and $4,000 for married persons or heads of families. No return of incomes not exceeding $3,000 will be required, as provided in the present law.

The time limit for payment of the income tax is changed from the 30th day of June, as provided in the present law to the 15th day of June. The purpose of this change is to

provide for the collection of the entire tax within the fiscal year and to make the penalty for nonpayment attach within the same fiscal year.

The section specifying the corporations exempt from tax has been reparagraphed and extended. It was deemed advisable to specifically extend the exemption to other corporations similar to those enumerated in the present law as exempt from tax in view of the fact that the experience of the Treasury Department has been that the securing of returns from them has been a source of expense and annoyance and has resulted in the collection of either no tax or an amount which is practically negligible.

The present law requires that the income tax shall be levied on the accrued basis. As two systems of bookkeeping are in use in the United States, one based on the cash or receipt basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or corporation may make return of income on either the cash or accrued basis, if the basis selected clearly reflects the income.

During the fiscal year ending June 30, 1917, it is estimated that the income tax proposed by this measure will yield from the incomes received or accrued during the calendar year 1916, $227,000,000, or about $107,000,000 more than would be received under the rates provided in the present law.

* * * * * *

Extract from Report of Committee on Finance.

64th Congress 1st Session. } SENATE. { Report 793 Part 1

TO INCREASE THE REVENUE.

August 16, 1916—Ordered to be printed.

Mr. Simmons, from the Committee on Finance, submitted the following

REPORT

(To accompany H. R. 16763).

* * * * * *
* * * * * *

Your committee has made very few changes in the income tax. The amendments suggested with reference to this title of the bill are as follows:

1. (To the additional, or surtax.) The House bill doubles the present normal tax. We recommend no change in that respect. The House bill increases the surtax on incomes over $500,000 only two-thirds. Your committee have added three new classifications to the additional or surtax provisions of the House bill and have increased the additional tax to a maximum of 13 per cent. upon the excess of net incomes over $2,000,000. This change will increase the revenue from this source about $2,500,000.

2. The House bill provides as an exemption, in the nature of a deduction from the amount of the net income of each individual taxpayer, the sum of $3,000, except where such person is the head of a family, when the said exemption shall be $4,000. Your committee recommends that this be amended so as to provide, as does the present law, for an exemption from the amount of the net income of each person the sum of $3,000, plus $1,000 additional for a married man with

a wife living with him, or plus the sum of $1,000 additional for a married woman with her husband living with her.

3. The committee amendment fixes as a basis for ascertaining the gains and losses from the sale and other disposition of property, real, personal, and mixed, acquired before March 1, 1913, the fair market value of such property as of March 1, 1913. The committee amendment also provides as a basis of deduction for depletion, in the case of oil and gas wells, a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow but by the settled production or regular flow; in case of mines a reasonable allowance for depletion, not to exceed the market value in the mine of the product which has been mined and sold during the year for which the return and computation are made; and in the case of timber, a reasonable allowance for stumpage not in excess of the market value of the standing timber actually sawed and sold during the year for which such return and computation are made.

4. The committee has added to the House bill a number of amendments, in the main suggested by the Treasury Department, for the purpose of simplifying and clarifying the administrative features of the act. It is not deemed necessary to enumerate these.

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* * * * * *

The Evening Post Job Printing Office, Inc., 134 Fulton St., N. Y.

Office Supreme Court, U. S.
FILED
JAN 11 1918
JAMES D. MAHER,
CLERK.

Supreme Court of the United States,

OCTOBER TERM, 1917.

No. 705.

CHARLES A. PEABODY,
Plaintiff-in-Error,

vs.

MARK EISNER,
Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

Motion to Advance.

TO THE HONORABLE THE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Now comes Charles A. Peabody, plaintiff-in-error above named, and respectfully moves the Court to ad-

vance the above entitled cause to be heard on March 4, 1918, for the following reasons:

Lynch v. *Hornby*, No. 421, and *Lynch* v. *Turrish*, No. 422, have been advanced on motion of the Solicitor General to be heard on March 4, 1918, and *Southern Pacific Company* v. *Lowe*, No. 452, has been advanced for hearing on the same date on motion of the plaintiff-in-error therein. Said causes all involve the question whether corporate dividends received after March 1, 1913, but paid out of earnings, profits or accretions accrued to the corporation prior to March 1, 1913, constitute taxable income of the stockholders within the meaning of the Income Tax Law of 1913. See decisions reported below: *Lynch* v. *Turrish*, 236 Fed. 653, *Lynch* v. *Hornby*, 236 Fed. 661, *Southern Pacific Company* v. *Lowe*, 238 Fed. 847. The same question is involved in the above entitled cause, *Peabody* v. *Eisner*, and constitutes the only question in the case, except that in the event of the construction of the tax statute in favor of the Government it will be necessary to consider also the question whether the statute as so construed can be enforced consistently with Constitutional provisions. The question arises in somewhat varying forms in the four cases owing to differences in the character of the several dividends involved, but the essential question of law is believed to be identical in all the cases.

This cause involves an extra dividend paid in 1914 by the Union Pacific Railroad Company, consisting in

part of cash and in part of capital stock of the Baltimore and Ohio Railroad Company. Plaintiff-in-error voluntarily returned in 1914, and paid taxes on, a portion of this dividend as taxable income, and in 1917 was subjected to an additional assessment of income tax on the remainder of the dividend, paid the same under protest, and sues for the recovery of the tax from the Collector of Internal Revenue. The decision below was rendered upon demurrer to the complaint. It appears by the complaint that the portion of the dividend upon which the additional tax was assessed was paid out of assets of the Union Pacific Railroad Company representing profits accumulated and existing prior to March 1, 1913, the date from which the Income Tax Law of 1913 was retroactively effective. It is claimed on the part of the plaintiff-in-error that the dividend, to the extent subjected to the additional assessment, was from the standpoint of the tax statute and the pertinent Constitutional provisions a *pro tanto* realization of the principal of his property interest and investment as it existed prior to March 1, 1913, rather than taxable income arising or accruing subsequently to that date. The cause was decided below without opinion other than a brief memorandum expressing the Court's belief that the question was ruled against the plaintiff in that district by the decisions in *Southern Pacific Company* v. *Lowe* (No. 452 in this Court, advanced as above stated to March 4, 1918) and *Towne* v. *Eisner* (No. 563 in this Court, reversed by decision announced on January 7, 1918).

This cause was instituted as a test case to determine the income tax liability of said extra dividend in the interest of all Union Pacific Railroad Company stockholders liable to super-taxes under the 1913 law. The dividend was received by upwards of 20,000 stockholders, and while it is not known how many of them enjoyed incomes rendering them liable to super-taxes, it is known that the number is sufficiently large to make the determination of the question of tax liability one of general public interest. The stockholders generally did not consider the dividend as income or return it as such, and consequently assessments of the dividend occur only as the revenue agents in the course of the re-examination of taxpayers' returns discover the omission and report the dividend for re-assessment. A considerable number of stockholders have already been assessed, both prior to and since the institution of this suit, and such re-assessments will continue until the revenue agents complete the re-examination of returns for 1914 of all taxpayers. Such assessments necessitate prompt payment of the additional tax under protest and subsequent filing of claims for refund. It is, therefore, desirable, not only from the standpoint of the large number of recipients of this dividend, but also presumably from the standpoint of the administration of the revenue office, that an early decision of the question of liability be obtained.

Motion to dismiss for want of jurisdiction was filed by the Solicitor General on December 10, 1917, and no decision of that motion has been announced, but the

jurisdiction of this Court of this cause appears to be established by the decision of the jurisdictional question in *Towne* v. *Eisner*, No. 563, announced on January 7, 1918.

WHEREFORE plaintiff-in-error respectfully moves this Court to advance this cause as aforesaid.

Dated January 10, 1918.

Respectfully Submitted,

HENRY W. CLARK,
Of Counsel for Plaintiff-in-Error.

Honorable JOHN W. DAVIS,
Solicitor General of the United States.

PLEASE TAKE NOTICE that the foregoing motion to advance will be submitted to the Supreme Court of the United States on January 14, 1918, upon the convening of the Court on that day.

Dated, January 10, 1918.

HENRY W. CLARK,
Of Counsel for Plaintiff-in-Error,
165 Broadway, New York City, N. Y.

The Evening Post Job Printing Office, Inc., 156 Fulton St., N. Y.

Office Supreme Court, U. S.
FILED
DEC 7 1917
JAMES D. MAHER,
CLERK.

Supreme Court of the United States

OCTOBER TERM 1917

No. 705

CHARLES A. PEABODY,
Plaintiff-in-error

vs.

MARK EISNER,
Defendant-in-error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR PLAINTIFF-IN-ERROR IN OPPOSITION TO MOTION TO DISMISS.

Statement of the Case.

In 1914 the Union Pacific Railroad Company declared and paid an extra dividend upon its common stock consisting of the following upon each share of such common stock: First, $3 in cash; Second, $12 in par value of preferred capital stock of the Baltimore

and Ohio Railroad Company; Third, $22.50 in par value of common capital stock of the Baltimore & Ohio Railroad Company [Complaint, paragraph III, Record, p. 3]. The plaintiff-in-error, who was also the plaintiff below and will be hereinafter referred to as the plaintiff, received said dividend upon his holding of 1100 shares of Union Pacific Railroad Company common stock [Complaint, paragraph IV, Record, p. 3]. In his income tax return for that year plaintiff included as taxable income only $4.12 of said dividend per share of his Union Pacific stock, or a total of $4532, and was assessed and paid income tax upon his net income so returned [Complaint, paragraph V, Record, p. 3]. In 1917 an additional assessment of supertaxes was made against the plaintiff on the balance of his said dividend as valued by the Commissioner of Internal Revenue, such balance at the Commissioner's valuation resulting in $36,718 of additional net income upon which the additional supertaxes amounted to $1468.73 [Complaint, paragraph VI, Record, p. 3]. Having paid said additional taxes under protest, and appealed to the Commissioner of Internal Revenue without success [Complaint, paragraphs VII and VIII, Record, p. 4], the plaintiff brought this action against the Collector for the recovery of said additional taxes.

The complaint consists of two causes of action: first, for the recovery of the entire amount of the additional taxes on the ground of the entire validity of the assessment, and second, for the recovery of a part of said additional taxes resulting from an alleged over-

valuation by the Commissioner of the Baltimore and Ohio shares included in said dividend. The defendant demurred to each cause of action, but thereafter entered into a written stipulation conceding an overvaluation of the Baltimore and Ohio shares and consenting to judgment under the second cause of action for the recovery of $188.50, this stipulation being without prejudice to the claims of the plaintiff under the first cause of action [Stipulation, Record, p. 9]. The District Court, considering that the first cause of action was ruled against the plaintiff in that court by the decisions in *Southern Pacific Company* v. *Lowe*, 238 Fed. 847, and *Towne* v. *Eisner*, 242 Fed. 702, sustained the demurrer to the first cause of action and dismissed the same, awarding the plaintiff only the aforesaid stipulated recovery under the second cause of action [Record, pp. 10, 11 and 12].

The plaintiff thereupon sued out a writ of error from this Court to the District Court to review the dismissal of the first cause of action, assigning as error: (1) that the dividend upon which the tax in suit was assessed did not constitute a gain, profit or income of the plaintiff arising or accruing on or after March 1, 1913, within the meaning of the tax statute, and (2) "that the taxation of said dividend, under the facts alleged in the first cause of action of the complaint, would constitute a levy of direct taxation without the apportionment required by the provisions of clause 3 of Sections 2 and clause 4 of Section 9 of Article I of the Constitution of the United States" [Record, p. 13].

Sufficient basis for these assignments appears in the complaint, both the foregoing propositions having been expressly asserted therein as grounds of recovery [Complaint, paragraph XVI, Record, p. 6].

The ultimate fact shown by the complaint, as the basis for the foregoing propositions of law, is that the portion of the dividend upon which the additional tax in suit was assessed was paid out of assets of the Union Pacific Railroad Company representing profits accumulated and existing prior to March 1, 1913, the date from which the income tax law of 1913 was retroactively effective, and the approximate effective date of the Sixteenth Amendment to the Constitution. On March 1, 1913, the aggregate assets of the corporation applicable exclusively to its common stock amounted to $167.46 for each share of its common stock [Complaint, paragraph IX, Record, p. 4]. This was the capital and accumulated surplus then represented by each share of common stock. The valuation ascribed to said extra dividend by the corporation was $33.30 on each share upon which the dividend was paid, this value resulting from the valuation of the Baltimore & Ohio Railroad Company shares at their then prevailing market prices [Complaint, paragraphs XI and XII, Record, pp. 4 and 5]. The dividend vested in stockholders on March 2, 1914, and on that date, after the charging off of said extra dividend, the aggregate assets of the corporation then remaining and constituting the capital and undistributed surplus applicable exclusively to its common stock amounted to $138.22 for

each share of such common stock [Complaint, paragraphs XIII and XIV, Record, p. 5]. That is, after the vesting of the extra dividend on March 2, 1914, the plaintiff's interest in the dividend, valued at $33.30 per share, and his interest in the capital and undistributed surplus, $138.22 per share, aggregated $171.52, as compared with his interest in the capital and accumulated surplus as it existed prior to March 1, 1913, of $167.46 per share, a difference of $4.06 per share [Complaint, paragraph XIV, Record, p. 5]. This difference of $4.06 per share represented the net profits of the corporation between March 1, 1913, and March 2, 1914, available for the payment of the dividend, that is, the profits remaining after the payment of interest and regular dividends [Complaint, paragraph XV, Record, p. 5]. Therefore the plaintiff in voluntarily returning $4.12 per share as taxable income returned slightly more of the dividend than was paid out of earnings and income of the corporation for the period between March 1, 1913, and March 2, 1914, and the tax in suit was based wholly upon the distribution of profits realized by the corporation prior to March 1, 1913.

ARGUMENT.

A substantial question as to the application of the Federal Constitution is actually and directly involved in the case.

The contention of the defendant-in-error is that the constitutional question, advanced by plaintiff as authority for a direct review by this Court, is not really involved in the case or in any event is frivolous. The decisions cited in behalf of the defendant-in-error need not be considered separately. They merely exemplify the well-established rule that the constitutional question asserted as the basis for a direct appeal to this Court under Section 238 of the Judicial Code must be a real and substantial question in the case. The applications of that rule in the cases cited have no special pertinency to the present case.

It is true that plaintiff asserts a question of construction of the Income Tax Law of October 3, 1913 (38 Stats. 166), contending that the terms of the statute do not require or sanction the taxation as income of a dividend or distribution of earnings accumulated by a corporation prior to March 1, 1913. But it is equally the theory of the case that, even if the tax law be construed as expressly authorizing the taxation of such a dividend, the tax in suit cannot be sustained consistently with the provisions of the Constitution. The two propositions are mutually independent. The *power* of Congress to tax all income whenever accruing and also to tax capital is conceded. But the

requirement of apportionment of direct taxes in Sections 2 and 9 of Article I of the Constitution has not been abolished or impaired, and the question still remains whether a given subject-matter of a tax levy, although called income by the tax law, is in reality principal or capital and the tax levy thereon direct and therefore requiring apportionment. The construction of the Income Tax Law as sanctioning the tax in suit and as classifying the subject-matter of this tax as income within its power to tax without apportionment, will neither foreclose nor affect the question whether the subject-matter of the tax is in reality of such a character that it may be taxed directly without apportionment.

The subject-matter of the tax in suit is not an ordinary dividend out of current earnings realized by the corporation after the adoption of the Sixteenth Amendment. It was an extraordinary distribution of earnings accumulated prior to the adoption of the Sixteenth Amendment. The plaintiff's property interest or investment prior to March 1, 1913, consisted of his proportionate share of the accumulated profits or surplus as well as the $100 of capital represented by each of his shares. Aside from the $4.12 per share of this dividend voluntarily returned by the plaintiff for 1914, every dollar of his dividend was paid out of the corporate accumulations represented by his stock prior to March 1, 1913, and then constituting a part of his principal. The extra dividend of 1914 was a *pro tanto*

realization of his property interest and investment as it existed prior to March 1, 1913.

Our assertion is that for the purposes of income taxation after March 1, 1913, under the amended scheme of income taxation resulting from the Sixteenth Amendment, corporate profits already accumulated on that date constitute an augmentation of the stockholder's investment and do not become income by their subsequent transmutation of form through the declaration of a dividend or through a sale. This theory cannot be disposed of by the argument that the stockholder has no title to the corporate earnings until declared as dividend. The stockholder's interest in the surplus earnings is precisely the same as his interest in the corporate capital represented by his shares. They augment the intrinsic and market value of his shares. They can be realized in cash, without awaiting a dividend, by a sale of the shares. They undoubtedly constitute a profit which can be taxed against the stockholder individually, even before a dividend distribution of them, if it is the policy of the tax law to tax profits before they are actually realized in cash. Indeed provision for the taxation of such undistributed earnings as profits of the stockholder, when improperly withheld from distribution, was made by Subdivision 2 of Sub-Section A of the Income Tax Law of 1913 (38 Stats. at 166) and Section 3 of the Income Tax Law of 1916 (39 Stats. at 758).

Income derived from stocks was expressly men-

tioned in *Pollock* v. *Farmers Loan & Trust Co.*, 158 U. S. 601, 618, as within the final ruling of that case that taxation of income from invested personal property was direct taxation subject to the rule of apportionment. If this be true of dividends, it must certainly be equally true of the taxation against the stockholder of the undistributed profits of the corporation.

In this situation, the question arises, in the first place, whether the Sixteenth Amendment was retroactive, whether under its operation income already accrued to and realized by a stockholder prior to the adoption of the Amendment and which could theretofore have been taxed only subject to the rule of apportionment, immediately thereafter became liable to retroactive taxation by a different rule, that is, without apportionment. The question has never been adjudicated by this Court. The question of retroactivity involved in *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, was whether the 1913 Income Tax Law offended against constitutional provisions by the taxation of income accrued *prior to its enactment, but after the effective date of the Sixteenth Amendment.* It has been impliedly recognized in the various income tax laws enacted since the adoption of the Sixteenth Amendment that the Amendment was not retroactive. The law of 1913 by subsection D thereof expressly limited the 1913 levy to net income accruing *from March 1* (38 Stats. at 168). The 1916 Act by Section 2 (*a*) defined taxable dividend income as limited to distributions of earnings accrued since March 1, 1913, and by Section 2 (*c*) provided that in comput-

ing profits derived from the sale or other disposition of property acquired before March 1, 1913, the fair market value of the property on that date should be the basis of computation (39 Stats. at 757 and 758). The Act of October 3, 1917, by its Section 1211 added to the income tax law a new Section 31 which retains and reinforces the provision that dividends paid out of earnings accrued prior to March 1, 1913, are not subject to the tax.

In the second place, assuming that the Sixteenth Amendment is not accorded retroactivity, the question arises whether under the facts pleaded, and admitted by the demurrer, the subject-matter of the tax in this case was not gain, profit or income accrued to the stockholder before the adoption of the Amendment rather than thereafter. Since, as already pointed out, the undistributed profits of the corporation accumulated prior to the adoption of the Sixteenth Amendment were a proper subject of the direct taxing power of Congress, but with the necessity of apportionment, it would seem that they could not be regarded as a new income, a new subject-matter upon which taxation could be levied without apportionment, simply by reason of their distribution in the form of a dividend after the adoption of the Amendment. Further, if the Amendment was not retroactive it would seem that whatever the taxpayer possessed at the time of its adoption as a part of his property interest or investment, whether a part of his original principal or augmentations thereto, constituted a part of his principal for the purposes of future taxation, and that a subsequent transmutation of the

form of this principal, resulting in no increase of his total wealth, should not be deemed income liable to a new method of taxation authorized for the future.

The foregoing are briefly and broadly the considerations involved in the plaintiff's assertion of the constitutional question. The only question of constitutional *construction* involved concerns the Sixteenth Amendment. But the primary and underlying question is whether the tax in suit, considering the facts and circumstances pleaded, and admitted by the demurrer, constitutes a direct tax, thus involving the *application* of the apportionment requirements of the 2nd and 9th sections of Article I of the Constitution. This was the proposition asserted by the complaint. Reference to the Sixteenth Amendment was properly omitted from the complaint, since such reference would have been in the nature of an anticipation of an argument belonging to the defendant. The Sixteenth Amendment is involved because of the *defendant's* assertion of it in answer to the plaintiff's proposition. The application of the 2nd and 9th sections of Article I is none the less involved, because of the concession of defendant-in-error that apportionment was required unless its necessity was dispensed with by the Sixteenth Amendment.

The Motion Should be Denied.

Dated December 3, 1917.

HENRY W. CLARK,
Of Counsel for plaintiff-in-error.

PEABODY v. EISNER, COLLECTOR OF INTERNAL REVENUE.

ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

No. 705. Argued March 4, 5, 6, 1918.—Decided June 3, 1918.

A dividend received by a shareholder after, from surplus profits of the corporation existing before, March 1, 1913, was subject to the "surtax" under the Income Tax Act of 1913. *Lynch* v. *Hornby*, *ante*, 339.

A dividend by a corporation of shares owned by it in another corporation is not a stock dividend and is subject to the tax, like an equivalent distribution of money. *Towne* v. *Eisner*, 245 U. S. 418, distinguished.

Affirmed.

THE case is stated in the opinion.

Mr. Henry W. Clark for plaintiff in error.

The Solicitor General, with whom *Mr. Wm. C. Herron* was on the brief, for defendant in error.

Mr. Robert R. Reed, by leave of court, filed a brief on behalf of the Investment Bankers' Association of America, as *amicus curiæ*.

MR. JUSTICE PITNEY delivered the opinion of the court.

This case arose under the Federal Income Tax Act of October 3, 1913, c. 16, 38 Stat. 114, 166. The controversy is over the first cause of action set up by plaintiff in error in a suit against the Collector for the recovery of an additional tax exacted in respect of a certain dividend

received by plaintiff in the year 1914, the facts being as follows: On and prior to March 1, 1913, and thenceforward until payment of the dividend in question, plaintiff was owner of 1,100 shares (out of a total of 2,000,000 shares outstanding) of common stock of the Union Pacific Railroad Company, of the par value of $100 each, and during the same period the company had large holdings of the common and preferred stocks of the Baltimore & Ohio Railroad Company. On March 2, 1914, the Union Pacific declared and paid an extra dividend upon each share of its common stock, amounting to $3 in cash, $12 in par value of preferred stock of the Baltimore & Ohio, and $22.50 in par value of the common stock of the same company; the result being that petitioner received as his dividend upon his holding of Union Pacific common stock $3,300 in cash, 132 shares of Baltimore & Ohio preferred and 247½ shares of Baltimore & Ohio common stock. In his income return for 1914 he included as taxable income $4.12 per share of this dividend, or $4,532 in all, and paid his tax upon the basis of this return. Afterwards he was subjected to an additional assessment upon a valuation of the balance of his dividend, and this, having been paid under protest, is the subject of the present suit, the theory of which is that the entire earnings, income, gains, and profits from all sources realized by the Union Pacific Railroad Company from March 1, 1913, to March 2, 1914, remaining after the payment of prior charges, did not exceed $4.12 per share of the Union Pacific common stock, and that the cash and Baltimore & Ohio stock disposed of in the extra dividend (so far as they exceeded the value of $4.12 per share of Union Pacific) did not constitute a gain, profit, or income of the Union Pacific, and therefore did not constitute a gain, profit, or income of the plaintiff arising or accruing either in or for the year 1914 or for any period subsequent to March 1, 1913, the date when the Income

Tax Law took effect. The District Court overruled this contention upon the authority of *Southern Pacific Co.* v. *Lowe*, 238 Fed. Rep. 847, and *Towne* v. *Eisner*, 242 Fed. Rep. 702. The latter case has since been reversed (245 U. S. 418), but only upon the ground that it related to a stock dividend which in fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest. *Southern Pacific Co.* v. *Lowe*, has been reversed this day, *ante*, 330, but only upon the ground that the Central Pacific Railway Company, which paid the dividend, and the Southern Pacific Company, which received it, were in substance identical corporations because of the complete ownership and control which the latter possessed over the former as stockholder and in other capacities, so that while the two companies were separate legal entities, yet in fact and for all practical purposes the former was but a part of the latter, acting merely as its agent and subject in all things to its direction and control; and for the further reason that the funds represented by the dividend were in the actual possession and control of the Southern Pacific Company as well before as after the declaration of the dividend. In this case the plaintiff in error stands in the position of the ordinary stockholder, whose interest in the accumulated earnings and surplus of the company are not the same before as after the declaration of a dividend; his right being merely to have the assets devoted to the proper business of the corporation and to receive from the current earnings or accumulated surplus such dividends as the directors in their discretion may declare; and without right or power on his part to control that discretion.

It hardly is necessary to say that this case is not ruled by our decision in *Towne* v. *Eisner*, since the dividend of Baltimore & Ohio shares was not a stock dividend but

a distribution *in specie* of a portion of the assets of the Union Pacific, and is to be governed for all present purposes by the same rule applicable to the distribution of a like value of money. It is controlled by *Lynch* v. *Hornby*, this day decided, *ante*, 339.

Judgment affirmed.